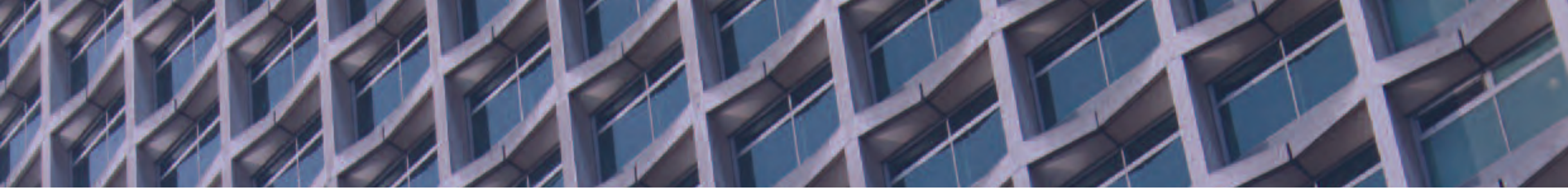
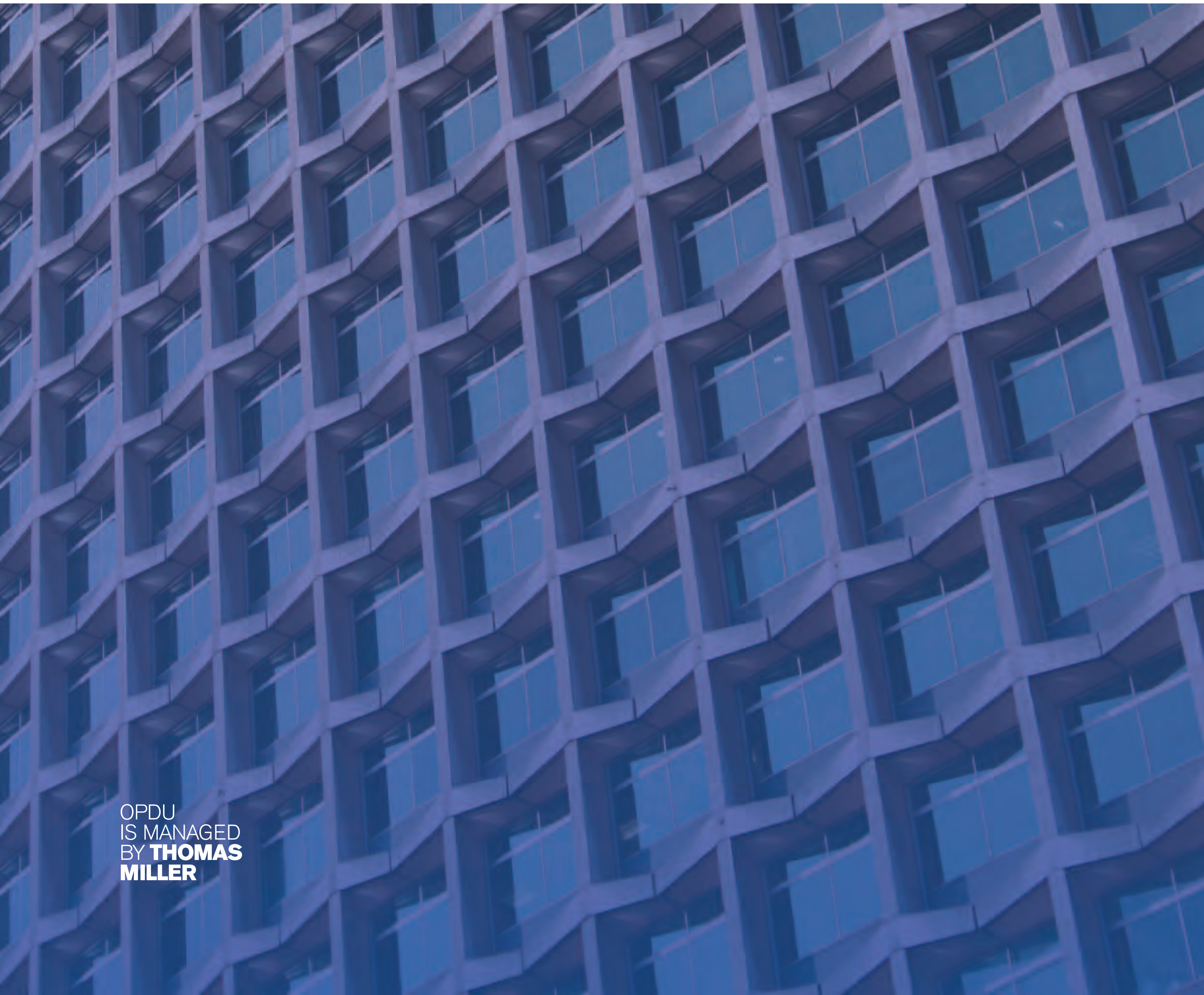


OPDU

Report 30

Protecting Trustees Pension Schemes and Sponsoring Employers



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OPDU Annual Meeting 2012
NEST and The Pensions Regulator look to the future

At **OPDU**'s Annual Meeting held at the offices of Reed Smith on the 26 January, Lawrence Churchill, Chair of NEST Corporation, responsible for probably the world's fastest growing pension scheme, described what he believed constituted good governance for defined contribution pension schemes at our Annual Meeting. He began his speech by paying tribute to **OPDU**'s leading role in providing insurance and risk services to trustees.

NEST is a new workplace pension scheme for low to moderate earners and has been designed to meet the challenge of companies having to ensure employees join a pension scheme automatically where there is not already an appropriate scheme in place. This new requirement will commence in the Autumn with the largest companies affected first, and then be rolled out over the next five years.

Lawrence drew upon the governance structure NEST had put in place which aimed to support the requirement to act in members' "best interests" which was not just the financial interest of obtaining the best return, but included broader areas such as having clear and low charges and jargon busting. He believes that governance should be proportionate to individual scheme circumstances and should not just be about cloning the approach taken by NEST. Lawrence concluded his address by looking ahead to future possible trends and predicted a healthy future for trust based pension schemes.

Jonathan Bull, **OPDU**'s Executive Director, had opened the Meeting welcoming the audience of 150 which included several eminent people from the pension's community. Peter Murray, Chairman of **OPDU**'s Advisory Council, then summarised the work undertaken by **OPDU** in the last twelve months. **OPDU** continued to provide the most comprehensive cover and support and was delighted to announce the introduction of lifetime cover for retired trustees which was designed to provide valuable peace of mind for individuals undertaking the onerous task of trusteeship. Another successful year for **OPDU** had seen its membership increase to 775 schemes with scheme assets of approximately £180 billion. Last year had also seen the launch of NEST which, together with the introduction of auto-enrolment, would potentially transform pension provision in this country. After being invited to tender, **OPDU** was delighted to welcome NEST Corporation and its trustees as an **OPDU** member.

The Chairman highlighted **OPDU**'s ability to routinely be able to provide cover of up to £30 million which was twice the market norm although higher limits could be arranged and £100m was currently the highest limit taken by a large **OPDU** member with several schemes insured under their policy. **OPDU** was also able to provide cover for the growing number of schemes being discontinued or wound up.

The Chairman reviewed examples of recent claims and notifications which were set against a background of continued financial turmoil. He concluded his address by congratulating those **OPDU** members whose schemes had been recognised by winning a number of leading industry awards.

Finally, Stephen Soper the Executive Director for defined benefit funding at the Pensions Regulator, gave a flavour of what was expected of pension scheme trustees for the coming year, highlighting what he believed was a flexible framework for sponsors and trustees against a challenging economic background.

Stephen announced that the Regulator would publish a statement in April to help trustees dealing with scheme valuations and recovery plans, setting out expectations of trustees starting the valuation process. The statement will be updated annually. The aim of the guidance is to reduce the number of recovery plans which would need to be scrutinised in depth or challenged by the Regulator. Stephen also summarised the Regulator's views on contingent assets, de risking and other corporate transactions and advised that it would be publishing details of cases in which it had been involved to assist trustees in understanding how the Regulator had used its powers, and in certain cases reached non-standard agreements. In summary, the Regulator was looking to adopt a more focused and proactive approach with the aim of interfering less in well-run schemes.

Following a lively and interesting question and answer session, a Reception was held with Reed Smith's offices providing outstanding panoramic views of London's changing skyline.

For full articles see page 8 for Lawrence Churchill and page 12 for Stephen Soper.

A Guide to Trustee Liability Insurance

Trustees have an increasingly difficult job to do. The Pensions Act 2004 increased the legislative burden on trustees giving the Regulator wide ranging powers if schemes are not being managed appropriately and various Codes of Practice have also been issued by the Regulator. Accordingly, the responsibilities of a trustee are onerous which is also borne out by claims experience which demonstrates that errors can occur even in the best managed schemes particularly in the increasingly dominant environment of defined contribution schemes.

The issue of protecting trustees from liabilities has also become particularly topical following the various headlines reporting the liability of trustees including the cases involving the incorrect authorisation of unsecured loans to sponsoring employers.

Liability for breach of trust is a personal liability and a trustee is liable to both the scheme beneficiaries and to scheme creditors. Professional advice should be sought when appropriate and failure to do so may in itself be held to be a breach of trust. If trustees are uncertain as to how to exercise their powers, they can also apply to the court for directions. The risk is potentially greater after a winding up when there may be missing beneficiaries or other contingent liabilities but no assets. A trustee or trustee director is also potentially at risk of having to pay a civil fine for breach of pensions' legislation. Fines for individuals range up to £5,000 and for corporate trustees £50,000.

Limited Protection: Exoneration & Indemnity clauses

Many trustees will have the benefit of clauses within the trust deed and rules exonerating them from liability and in many instances, an indemnity may be given by the scheme or the sponsoring employer company. However, it is not always appreciated that such clauses are subject to statutory limits. For example, an exoneration or indemnity from the fund cannot operate for any breach of trust relating to investments and it is also prohibited for the scheme to indemnify trustees for civil fines and penalties. It should also be appreciated that an indemnity from the employer would be of no value upon an insolvency when the trustees are still having to manage the scheme.

Exoneration clauses are also subject to several other limitations including not affording protection from claims involving third parties and they will always be construed restrictively by the courts. In addition, the problem with relying purely on exoneration and indemnity provisions is that they merely transfer any liability between the trustees, the beneficiaries and the employer. More importantly why should a pension member, who has a valid claim, be defeated by a legal technicality i.e. an exoneration clause. In today's environment, trustees do not usually wish to "hide" behind exoneration clauses when facing such claims.

Wider Protection: Insurance

In these circumstances, insurance is playing an increasingly important role in protecting trustees and pension scheme assets. It provides an

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external resource of protection and should stand in front of such indemnity and exoneration clauses. The purchase of a properly drafted and comprehensive insurance policy can be a cost-effective means of protecting member' benefits, individual trustees, the sponsoring employer, pension managers and internal administrators from losses resulting from claims, be they well-founded or not.

If the decision is taken to adopt insurance, however, it is important to have a policy specifically designed to respond to the needs of trustees and other individuals involved in the management of pensions. This is highlighted by the potential conflicts of interest which commonly exist when a trustee is also a director of the sponsoring employer company with duties to the company and its shareholders. As a trustee, however, there is an overriding duty owed to the scheme beneficiaries which is paramount. Accordingly, it is not recommended that reliance be placed upon a Directors & Officers (D&O) policy of insurance as the cover will not be tailored to meet the specialised circumstances relating to pensions and potentially there will be competing calls on the policy. Furthermore, D&O policies will often contain an exclusion for any acts or omissions while acting as a trustee or administrator of the pension scheme.

Retired trustees

A trustee's personal exposure does not cease when they retire and their post retirement situation may make them particularly vulnerable. Problems in pensions also often take a considerable time after the event to materialise. It is important, therefore, to check that the position of retired trustees and pension managers is properly protected. The solution is for retired trustees to have the guarantee of cover in the event that the scheme ceases to be insured. They can then rest assured that they have cover personal to them, irrespective of what the employer or trustees have done, or not done, about insurance since they retired. It is again important to check the extent of cover provided in this respect as policies do vary (OPDU Elite provides lifetime cover for retired trustees from the date of expiry of the main policy of insurance thus giving valuable peace of mind).

What should be covered?

The following is a guide to the main headings of cover which can be included:

- Errors and omissions
- Damages, judgements, settlements
- Regulatory civil fines and penalties
- Ombudsman awards
- Defence costs
- Full severability of cover
- Individual representation
- Maladministration
- Public relation expenses
- Extradition proceedings/bail bond costs
- Prosecution costs
- Employer Indemnities
- Exonerated losses
- Litigation costs
- Retirement cover – lifetime
- Costs re investigations by regulatory authorities
- Media & Arbitration
- Court Application Costs
- Third Party Provider Pursuit Costs
- Emergency Costs
- Discontinuance insurance for schemes in wind-up.

Court Applications

Trustees and pension schemes can also incur significant legal expense in going to court to seek directions or if they are joined by another party who is seeking the court's directions. Insurance can be obtained to cover these expenses which do not necessarily involve a legal liability upon the trustees although the scheme will usually be responsible for the legal expenses of all the parties involved. There have been several high profile cases involving costs in excess of £1m which have had to be met from pension scheme funds. (OPDU Elite provides an extension to reimburse such costs – it is important to note that this type of legal expense would not usually fall within the scope of "defence costs" as defined in many insurance policies).

Claims Experience

OPDU's own claims experience has seen issues which have involved individual claim sums of up to £20m to date. One common feature is, as one would anticipate, the importance of the accuracy of data and we encourage trustees therefore to ensure that regular data healthchecks are undertaken. Other issues which have given rise to problems and potential liabilities include: incorrect formulas used for calculating benefits; interpretation of Trust Deeds; overpayment of benefits; misapplication of Scheme Rules; seeking court directions; early retirement & ill-health disputes; rectification proceedings, accounting irregularities; DC choices of investment funds; Pension Sharing Orders; general administration errors; TUPE issues; misrepresentations by trustees; transfer values; incorrect quotations; discrepancies between scheme documentation and administration practice; delays in transfer and payments of benefit assets; and PPF levy issues.

Cost

The cost of trustee liability insurance varies according to the size of the scheme but is also dependent on several other factors. However, the cost starts at a few thousand pounds for a small scheme and an approx-imate indication of cost should be able to be obtained easily for any size of scheme without having to complete a full application.

Conclusion

By taking out insurance, trustees can be confident that they have protection against the liabilities that might arise in performing their duties while also giving members comfort that their interests are being looked after properly in preserving the fund assets which is particularly important today when deficits are common.

Jonathan Bull
Executive Director, OPDU Limited
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See page 55
Trustee Liability Insurance Q & A's

Introducing the Association of Member Nominated Trustees

If you're a hard-pressed member-nominated trustee or director of a pension scheme, you may feel it would really help if you could find others in a similar position to discuss issues of concern. Is there a problem your scheme is facing and you'd like to hear from others how they addressed the same issue? Would you like to find out how you can access news, knowledge and information that would help your trustee role? Do you believe that trustees should be consulted by the powers that be and have their voice heard? Then the Association of Member Nominated Trustees is the place for you.

The AMNT was established less than two years ago by a small group of trustees from defined contribution and defined benefit schemes. They set it up because they felt there was a clear need from member nominees to be more appropriately supported, thereby enabling them to make a greater and more active contribution to scheme governance, and to more effectively voice their collective opinions. No other organisation is organised by and for member-nominated trustees.

In the short time since AMNT was formed it has grown into an organisation of 240 members from 180 different pension schemes, with collective assets of more than £200-billion.

The organisation aims to support the development of member nominees and to enable them to perform their role to the best of their ability. It provides access to pensions industry publications, many of which trustees can subscribe to for free, and it aims to provide or guide access to training services which meet their needs. AMNT has already begun to identify best practice among pension schemes.

Particularly popular has been AMNT's creation of a networking environment through which member nominees can share their experiences and challenges with other member nominees in confidence. We hold quarterly meetings that all members can attend, providing speakers on issues that MNTs consider important, and allow plenty of time for people to chat informally.

Also driving the AMNT forward is its role in providing member nominees with a collective voice, and it has lobbied effectively on pension matters with the Pensions Regulator, within the pensions industry and with the government.

The members of the AMNT are drawn from an inspiringly wide range of occupations. Some typical day jobs include: editor, pilot, development and quality manager, senior buyer, systems analyst, chemical scientist, bus driver, financial controller, managing director, librarian, client manager, electrician, chief draughtsman, plumber, minister, chief executive, bursar, and retired... in summary typically very bright people from all walks of life - well familiar with expectations of needing to learn to do a job professionally.

They are also typically very busy people who have put themselves forward to do a job on behalf of their work colleagues - and often someone who is well respected by co-workers and not unusually the first port of call for members who have issues or uncertainties with their pension schemes.

The AMNT is run by a committee whose co chairs are Janice Turner, a trustee of a private sector DB scheme, and Barry Parr whose experience is DC. Under their leadership the organisation has developed policy initiatives in consultation with the membership.

With DB, AMNT has worked hard to change some of the rules and regulations that MNTs feel have undermined their schemes. More recently, in response to demand, AMNT's DB working group has begun organising a defence unit to assist DB trustees who are faced with scheme closures. The aim is to help those trustees to ensure that all alternatives to closure are pursued.

On DC, the AMNT believes that the current offering of DC schemes is generally a poor deal compared with the offer in other European countries and further afield, and the organisation is working with other like-minded parties to investigate what alternatives could be introduced. Many DC trustees fear fielding complaints from scheme members that their pensions are worth less than the money they put in, and want the AMNT to work with all those who want British working people to be offered a better deal.

On training, the organisation is proud to have worked with The Pensions Regulator to improve and relaunch their excellent toolkit, which AMNT considers to be the foundation stone of trustee training.

AMNT benefits from support from the pensions industry in the form of a network of Friends who have very kindly hosted AMNT meetings and given other support in kind.

The organisation is devoting its energies this year to expanding its membership, developing its website so as to list upcoming training courses, continuing to work on a better DC offering, and defending DB schemes.

AMNT Association of Member Nominated Trustees

Membership is open and free to member nominated trustees, directors and representatives of public sector and private sector schemes Go to **www.amnt.org** to join and get involved in a forward-thinking, proactive organisation that provides support and a voice for member nominated trustees.

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Some Key Issues for Trustees

Here are just some of the issues that are currently on the radar for trustees:

Automatic Enrolment (1)

The Pensions Regulator has published a five step action checklist for trustees which are a useful starting point for trustees in their planning process. It is not just companies who are likely to be affected.

Automatic Enrolment (2)

The staging date (the date from which the new requirements apply) is based on the company's largest PAYE scheme so trustees should know when this is and be working with the company in assessing whether their scheme is to be used to meet the requirements. If so, will it meet the qualifying criteria for existing and new members? Trustees should also be liaising with their pension provider as it is by no means certain that they will allow the Scheme to be used for all those eligible to join under the automatic enrolment requirements.

Automatic Enrolment (3)

Trustees should also review potential scheme rule changes, administration processes, investment choices and retirement processes, as well as Scheme charges. A sub-committee including employees from different company functions, together with trustee representation, may well be appropriate. Letting the scheme members know how the changes will affect them and when they will take place is also important.

Improving Defined Contribution Schemes

The Pensions Regulator has expressed its concern about "mixed standards" for defined contribution schemes, particularly amongst smaller schemes. Its six principles are designed to establish an understanding of what a good defined contribution scheme looks like, particularly as these schemes are likely to dominate the market for meeting automatic enrolment requirements. Trustees may wish to assess how well their schemes meet these requirements and many are also considering the Investment Governance Group principles and the Pension Regulator's statement on the role of trustees in defined contribution schemes.

Making the Right Pension Choices

Research undertaken for the National Association of Pension Funds (NAPF) by the Pensions Policy Institute (PPI) has warned about the consequences of high pension charges and selecting the wrong annuity. The research suggests that to get the same level of pension, uncompetitive pension charges could delay an individual's retirement by three years and not choosing the most competitive annuity at retirement could mean an individual has to retire two years' later.

Europe (1)

The outcome of the European Insurance and Occupational Pensions Authority (EIOPA) advice to the European Commission on introducing Solvency II style funding to occupational pension schemes is awaited. The Pensions Regulator, in its corporate plan for 2012-2015, has prioritised working with the pensions industry, UK government partners, and EIOPA to ensure the UK position is recognised in Europe and the right outcome is achieved for UK pension schemes. Very much a question of 'watch this space'.

Europe (2)

Many defined benefit schemes now have liability driven investment strategies as part of their Scheme investments. Trustees of such schemes should be aware of the Markets in Financial Instruments Directive (MIFID) and Basel III proposals which could force the schemes to put more collateral against transactions and may require clearing houses which may not accept certain types of derivatives. Trustees of schemes which hold such investments will want to assess the potential implications for their investment strategy.

Scheme Funding

The current economic environment is a challenging one in which to balance the protection of members' benefits without undermining the viability of companies whose support is vital to the schemes that provide these benefits. The Pensions Regulator has published a statement aimed at trustees and companies who are undertaking scheme valuations with an effective date between September 2011 and September 2012. It has followed this up with some case examples which focus on scenarios for scheme funding plans in the present economic conditions. For those currently involved in the valuation process, this builds upon previous statements and the Code of Practice on funding defined benefit schemes, as guidance to be taken into account when finalising scheme funding negotiations.

Data Protection

This is an area which may not receive as much publicity as some others. The Information Commissioner's office has issued guidance on whether an organisation is a data controller or a data processor for compliance with data protection requirements. The guidance may well lead to pension scheme actuaries and pension scheme auditors being reclassified as joint data controllers rather than mere data processors. The distinction is important as data controllers remain responsible for ensuring that their data processors comply with data protection requirements. According to the new guidance, where the organisation handling the data is someone who requires "specialist qualifications, licences, or other authorisations to provide certain services", that organisation will be a data controller. The guidance recommends that Trustees, actuaries and auditors put in place an agreement to allocate appropriately responsibility for data protection compliance.

Data

Schemes should be considering the standard of their record keeping in order to meet the Pension Regulator's expectations for Common and Conditional data. Many schemes are going further than simply testing for the presence of data and undertaking additional checks to test the accuracy of their data.

Pensions Bill (1)

Reform of the State pension system will be set out in the Pensions Bill. This will provide for the State Pension Age to be increased from age 66 to 67 between 2026 and 2028 with plans for the State Pension Age to rise in line with improvements in life expectancy. It will also provide for a flat rate Basic State Pension of £140 a week in place of the current Basic State Pension and State Second Pension.

Pensions Bill (2)

Reform of public sector pensions will be set out in the Public Service Pensions Bill. The aim is to establish a common framework for public sector pensions and ensure that the schemes are sustainable with costs shared more appropriately between employers, public sector workers and taxpayers. The changes in both of the Pension Bills have previously been announced and are subject to consultation.

And this ignores.....

Exercises to identify statutory employers and any associated debts, a variety of pension de-risking exercises including enhanced transfer values, pension increase exchange and early retirement exercises, buy-ins, longevity swaps, Master Trusts, challenging investment markets, Financial Support Directions, Contribution Notices and GMP equalisation.

It looks like a busy few months ahead for trustees and their advisers.

Cover enhancements to the OPDU Elite Policy

OPDU regularly reviews its policy wordings with its underwriters ACE to ensure that it continues to provide the most extensive insurance cover available designed to protect the personal liabilities of trustees and the assets of the pension scheme and sponsoring employer.

Accordingly, new enhancements of cover are being introduced including importantly, extending the protection provided for retired trustees from 12 years to lifetime cover. This will provide individual trustees with valuable peace of mind in their retirement when they no longer have any say in whether their pension scheme should purchase insurance cover.

Access is also given to OPDU's specialist services which include a professional claims handling service provided by a team of in-house lawyers and pension professionals who deal with claims in a sympathetic manner in conjunction with your own advisors. OPDU also provides advisory and risk management services including a confidential advice line for trustees and administrators.

OPDU is pleased to assist whether your insurance needs relate to a current scheme or one that is being wound-up and the trustees and employer require discontinuance or run-off.

Claims

Some typical examples of the subject matter of claims in which OPDU has been involved:

- **Incorrect formulas used for calculating benefits**
- **Interpretation of Trust Deeds**
- **Overpayment of Benefits**
- **Misapplication of Scheme Rules**
- **Seeking Court Directions**
- **Early retirement & ill-health disputes**
- **Rectification proceedings**
- **Accounting irregularities**
- **DC choices of investment funds**
- **Pension Sharing Orders**
- **General administration errors**
- **TUPE issues**
- **Misrepresentations by trustees**
- **Transfer Values**
- **Incorrect quotations**
- **Discrepancies between scheme documentation and administration practice**
- **Delays in the transfer and payment of benefit assets**
- **PPF levy issues**
- **Equalisation issues**
- **Scheme amendment issues**

The issues have involved individual claim sums ranging up to £20m.

Annual Meeting Speaker:

The changing face of good governance

Lawrence Churchill CBE *Chairman NEST Corporation*

Building public trust in financial services is crucial for the success of automatic enrolment. Good governance and sound regulation are the foundations for building this trust.

This article asks what we mean by good governance and is trusteeship future-proofed?

Automatic enrolment is coming

There's a pressing need to examine these issues in the run-up to automatic enrolment. This is going to see millions of people enrolled in defined contribution (DC) pension schemes. These new savers need to know they can trust us and other providers with their money.

As the Chair of the Trustee for the National Employment Savings Trust (NEST), I have a particular interest in making sure we get this right.

NEST has been established by government as a qualifying scheme that employers can use to meet their new duty to provide a workplace pension scheme. It's been created to have low charges, a focus on clear communication and to be easy to use for employers and members. It's also been designed with a specific type of member in mind – those new to pension saving.

NEST has a public service obligation to accept any employer that wants to use us and we expect to be working with hundreds of thousands of employers as automatic enrolment is introduced. This means that NEST is likely to be one of the fastest growing pension schemes in the world.

For this reason we're putting in 'industrial strength' governance at this early stage to help manage our rapid growth. Governance is part of our strategy for making NEST work and one of the critical success factors for the organisation.

We've faced some specific challenges with regard to governance, and in this article I'll be looking at the steps NEST has taken to establish the type of governance structures that a scheme like ours needs.

What is good governance?

Governance is a topic that's grown increasingly important since the global financial crisis. This has led to a number of initiatives from regulatory and industry bodies to address good governance across all areas of business. For example:

- The Pensions Regulator (TPR) issued a statement on the role of trustees in October 2011, and issued its six principles of good workplace DC scheme governance in December of that year.
- The Department for Business, Innovation and Skills is sponsoring the Kay Review to look at short-termism in the UK equity markets.
- The Financial Reporting Council (FRC) has updated its Corporate Governance Code and Stewardship code for listed companies and asset owners.
- The Walker Review addressed governance of banks and other financial institutions in November 2009.
- The European Commission consulted on corporate governance frameworks early last summer and published over 400 responses in November 2011.

The Pensions Regulator's six principles

Of particular interest are TPR's six principles for workplace DC schemes. These provide a framework against which a DC scheme can judge its performance.

The six principles are:

1. **Schemes are designed to be durable, fair and deliver good outcomes for members.**
2. **A comprehensive scheme governance framework is established at set-up, with clear accountabilities and responsibilities agreed and made transparent.**
3. **Those who are accountable for scheme decisions and activity understand their duties and are fit and proper to carry them out.**
4. **Schemes benefit from effective governance and monitoring through their full lifecycle.**
5. **Schemes are well-administered with timely, accurate and comprehensive processes and records.**
6. **Communication to members is designed and delivered to ensure members are able to make informed decisions about their retirement savings.**

These principles underline the growing importance of governance frameworks and the expertise of trustees. This is addressed in the first three principles. Record keeping, administration and communication are seen as the key to enabling good governance and are outlined in the second three principles.

They are an excellent starting point for considering a scheme's approach to governance. At NEST, we've looked hard at our own governance processes to check that they measure up.

NEST knows that it will be in the public spotlight and faces increasing scrutiny. This is to be welcomed across the market. But NEST is not the only new scheme in the UK aimed at helping employers meet their automatic enrolment duties. Savers and stakeholders should also be given the chance to judge the relative strength of governance across alternative schemes.

My intention is that NEST will assess its performance against these principles and my challenge would be: Could we all report annually on this basis?

The evolving interpretation of members interests

Fiduciary duties for trustees of trust-based schemes are a product of case law and custom built up under common law. It's an evolving body of law that generally reflects the times. In relation to pensions, it's increasingly understood that members' interests are more than just the narrow financial interests expressed as investment return, often without enough emphasis on the risks involved.

NEST is aiming to innovate by adopting a broader interpretation of the Trustee's fiduciary duty, and is focused on how members can secure a good pension. We have therefore taken decisions designed to:

- Keep members contributing: Maintaining contributions means a member continues to benefit from contributions from their employer and tax relief. Our research has shown that while investment performance will clearly be important in growing members' savings, the effect of individuals making regular contributions is always going to be the dominant factor in members' outcomes.
- Ensure that communications with members are meaningful: Clear, timely communications can empower members to make the better decisions for themselves. NEST's policy of banning jargon, set out in our phrasebook has been widely welcomed. A copy of the phrasebook is available at www.nestpensions.org.uk/phrasebook
- Provide low charges: Transparent charges that provide value for money and are a benefit to members. NEST has the sort of low charges that have previously only been enjoyed by members of the largest schemes or high net worth individuals. We're also explaining total charges incurred by members.
- Develop suitable default funds: With many members staying in default funds, more emphasis could be placed on the duty to ensure that these serve members well. For example, Trustees should be able to draw a line of sight between their investment strategy and fund objectives and the risk appetite and risk capacity of their members. They should also assure themselves through outcome modelling that the target investment returns will be met in the majority of cases in a variety of economic scenarios.
- Provide a degree of choice for funds: Members can be expected to keep saving if they are comfortable with the fund they're investing in. As a result NEST offers two additional funds based on risk appetite and two funds based on values and beliefs.

- Promote sustainability: Consideration could be given to the longer-term impact of investments on society and the environment while delivering risk-adjusted investment returns over the long term.

Good governance and NEST – what we mean by 'industrial strength' governance

Good governance is as much about culture as processes. We believe in outcome-focused governance, rather than just examining the inputs and processes. Our behaviours – the way we do things – should be driven by members' interests.

At NEST we're putting in strong governance practices early on. We expect to grow rapidly after automatic enrolment begins in October, and so we want to ensure that we have robust governance in place to cope with this rapid growth. Our governance philosophy: We believe that good governance is in members' interests. We believe that best practice should be drawn from a variety of sources, and that pre-existing best practice protocols should be adopted where they are relevant.

Our governance structures: Our governance is structured into four main groups: the Trustee, the Member Panel, the Employer Panel and the executive team.

The Trustee is made up of the Chair and up to fourteen Trustee Members. They are selected based on quality and experience and to reflect diverse skills and viewpoints from the pensions industry and public life. Trustee Members currently include actuaries, investment specialists, a lawyer, financial services professionals, accountants and consumer specialists. Trustee Members are remunerated.

For efficiency, we have formed Trustee Committees covering audit, risk, nominations and governance, remuneration and culture, and investment. These reflecte current leading practice from the corporate sector by:

- separating the risk committee from the audit committee
- having governance as a remit for a committee;
- addressing culture and corporate responsibility (as well as pay and rations) through the remuneration committee.

Our Member and Employer Panels are required by the Order and Rules that established NEST. They fulfil a similar role to member-nominated Trustees in other trust-based structures. They report to the Trustee via the Chair, and provide a formal route for the people using NEST to participate in the development and operation of the pension scheme. They are independent of the Trustee and produce an independent annual report. Both panels use the resources of Nest Corporation and may commission their own work.

At NEST the executive team does not form part of the statutory governing body and derives its powers from those delegated by the Trustee to the chief executive. It is grouped into functions, covering our operations, and is shaped in line with other corporate organisations. In line with best practice, the heads of control and governance functions report directly to the respective committee chairs as well as to the chief executive.

NEST Corporation has a dual status as both a Trustee and a non-departmental public body (NDPB) that's unique in the pension industry. Our NDPB responsibilities operate in parallel to this corporate structure. The Chair reports to parliament via the Secretary of State. The CEO is also the Accounting Officer and in that capacity reports to the permanent secretary of the Department of Work Pensions.

Public sector requirements are a key part of our makeup. We have the same rigorous approach to remuneration, audit and accounting that are expected throughout the public sector. Tensions could perhaps arise between our public sector duties and our fiduciary duties. We have agreed with DWP that in the event of a conflict, we will work together to reach a mutually acceptable solution. However, where a conflict cannot be resolved, the fiduciary duty will take precedence.

Responsible ownership

It's in NEST members' interests that the companies we invest in are well governed and likely to produce sustainable and stable growth for decades to come.

We want to protect and enhance the value of NEST's investments over the long term, and to do this we believe that NEST must act as a responsible asset owner and market participant. For us, part of this duty is about considering environmental, social and governance (ESG) issues across all the asset classes and markets we invest in on behalf of our members, as well as exercising our voting and engagement rights.

To this end NEST adopts the FRC's Corporate Governance Code and has signed their UK Stewardship Code, which is a set of good practice principles that aim to improve the way companies and shareholders work together in the long-term interests of shareholders. We are also a signatory to the United Nations-backed Principles for Responsible Investment (UNPRI). These encourage consistent standards for responsible investment around the world.

We're currently working with our responsible ownership partner, The Co-operative Asset Management (TCAM), to help us engage with the companies we invest in and formulate our views on ESG issues, including executive remuneration, boardroom diversity, water and carbon emissions and labour practices.

TCAM is also supporting us in developing processes on vote monitoring and helping NEST understand when it should move to collective action when it comes to engaging with companies.

All of this will help us 'walk the walk' on acting as a responsible asset owner and help safeguard sustainable returns in the long term for our members.

Looking ahead – are we future-proofed?

The pensions industry is never static. It can't afford to be and must react to changing times.

Right now we can see changes in the way schemes are structured. Defined benefit (DB) schemes appear to be entering their final stages, and the concept of shared risk is being brought to the fore.

In the future, will the interpretation of fiduciary duties come to encompass financial literacy more generally? It's surely in members' interests to understand more about how savings work and the fundamentals of good financial planning.

Consolidation within the industry will lead to economies of scale, as we've seen in Australia. Increased economies of scale must surely go hand in hand with reducing agency costs and improving the risk/reward framework at lower cost.

We may also see regulation for trust and contract based schemes come together. In addition, we must keep abreast of efforts to harmonise pension provision across the European Union through initiatives such as the planned revision of the Directive on Institutions for Occupational Retirement Provision.

For NEST, 2012 brings the advent of automatic enrolment. NEST will be used by companies in the earliest stages of employer duties, which will see our membership grow quickly. It is not widely recognised that around forty percent of NEST's target market is employed by large companies.

We've put in place distribution partnerships with leading insurers, where NEST can be used alongside other schemes, thus helping each class of worker to get the most appropriate scheme.

Inevitably NEST will be challenged on its culture and values. The questions of good governance are enormously complex, and we'll doubtless find areas where we can do better. We hope that we can bring fresh ideas to the sector and continue to contribute to raising the standards of governance throughout the industry.

Lawrence Churchill CBE
Chairman NEST Corporation

Annual Meeting Speaker:

DB in 2012

Stephen Soper *Executive Director for Defined Benefit Funding at the Pensions Regulator*

The economic climate, flexability in pension scheme funding, and our expectations of trustees.

One of the biggest challenges facing trustees of DB schemes is the current uncertainty surrounding the key factors impacting their scheme valuations. Increasing life expectancy, a lack of confidence in the UK's economic recovery, uncertain investment returns, low interest rates and low gilt yields have all come together to increase liabilities and deficits. Low confidence and uncertainty in the economy make judging affordability difficult.

Overview

During the past four years of economic turbulence, the scheme specific funding framework has provided the flexibility necessary to support sponsoring employers and trustees to find appropriate funding arrangements that protect the scheme, whilst at the same time being affordable and reasonable for the employer, but we want to do more to help trustees, their advisers and sponsoring employers to understand our stance and recently published a statement to help trustees undergoing their valuations in the coming months.

We plan to make this an annual statement, helping trustees to understand our expectations within the prevailing economic conditions. By publishing a periodic statement in this way, it is also our hope that when we start to receive recovery plans for this group of schemes, fewer will require in-depth scrutiny from us as, by following the guidelines in the statement, they are more likely to reach funding agreements that we find acceptable. We also hope this will enable the process to be faster, and provide more certainty for employers, trustees and investors on how recovery plans will be treated.

The statement is relevant to all trustees and employers with a DB pension scheme, though is specifically aimed at those schemes who are undertaking their scheme valuations with effective dates in the period September 2011 to September 2012. This means it applies to about one third of the UK's 6,500 DB schemes, and about 4m of the 12m DB memberships.

It sets out our views on how the valuation process should be approached in the current economic environment, in order to protect members' benefits without damaging the viability of employers, whose support is vital to pension schemes. Our analysis shows that most schemes and sponsoring employers should be able to meet their pension promises to members with either no change, or only small changes, to their present deficit recovery plans. Trustees must produce credible recovery plans in light of all the risks, including employer insolvency.

Employers that are struggling have greater breathing space to fill deficits over a longer period. However, we will draw a distinction between this group and those cases where schemes are substantially underfunded and employers are able to afford higher contributions. In such cases we will expect pension trustees to be taking steps to put their scheme on a more stable footing.

The actual outcomes for schemes will be dependent upon the scheme and employer circumstances and on the results of their individual valuations, yet to be carried out, which cannot be fully forecast. We will be monitoring these results as they emerge to understand any divergence from expectations.

Non-cash scheme support

Over the past couple of years we have seen trustees make increasing use of the flexibility in the funding framework. Our view remains that the best support for a DB scheme comes in the form of direct cash contributions. However, we under-stand that it is sometimes in the interests of both the sponsoring employer and the pension scheme, for example where cash flow is constrained, to look for alternative forms of support.

This support might come in the form of contingent assets – assets to which the scheme can only lay claim if there is a 'contingent event', such as a funding shortfall below a certain level or the deterioration of the employer's covenant - or other forms of security, such as group or parental guarantees.

We have also seen an increase of incorporating asset-backed contributions (ABCs) and special purpose vehicles (SPVs) into recovery plans as another alternative. Although many of the same issues arise as with contingent assets, these arrangements differ in whether the scheme directly owns the assets, or benefits from an income stream from the assets. If the SPV is within the employer group there will also be 'employer-related investment', or 'ERI' issues for the trustees to consider. The ERI risks are not only that the whole structure could prove to be illegal, and therefore potentially worthless, but also that the scheme could be imprudently concentrating risk - making the scheme even more dependent on the success or failure of the employer group.

As detailed in our 'Monitoring employer support' guidance, we expect trustees to be confident that any form of contingent asset, or other security, is legally enforceable, and that an appropriate value is placed on it.

We recognise that there will be times where a well put-together structure may be of benefit to the scheme and this is something we could support. But we also know that these structures are being promoted heavily and that there is speculation that the regulator has encouraged or approved many of these types of arrangements – this is not the case. Trustees should not assume that an ABC or SPV will always be in the scheme's interests. It is important that there is a firm grasp of the risks involved and that proper due diligence has been carried out. We would not expect trustees to allow a structure to be put in place that increases the time it takes for the scheme to reach its funding target.

Trustees should take professional advice, and should be prepared to challenge that advice and to use common sense to decide whether the structure really does provide better scheme security than the alternative – a standard recovery plan.

Above all, as for any type of asset, we expect trustees to ascertain the genuine value of the assets, and to be comfortable with how this value could be realised for the scheme in the future. It can be particularly difficult to value some asset classes such as brands. Should it prove necessary to realise assets that are closely related to the employer, this will often be against a background of difficult trading conditions or even the employer's insolvency. In such a scenario, the value of the asset to the scheme may quickly fall, and, ultimately, could prove worthless.

We have also noted that putting in place ABCs and SPVs can involve a significant investment of time and money. It's important that the scheme receives the highest possible benefit from this investment, and that trustees carefully consider whether such resources would be better deployed as direct contributions to the scheme. We also encourage trustees to request at the outset that employers refund the scheme's adviser costs.

Corporate transactions

We recognise and appreciate the importance of corporate transactions in stimulating growth, and in creating and preserving jobs. Adaptable, flexible, and financially stable businesses play an important part in the UK's economic recovery. However, corporate transactions where pension schemes are involved should not happen at the expense of promises made to scheme members. In appropriate circumstances, we are fully committed to investigating and taking action to ensure that members are protected.

Our expectation of trustees faced with any corporate transaction is that they will maintain a dialogue with the employer and will fully represent the interests of the scheme members, working hard to ensure that adequate security is in place to secure their benefits. We also expect employers to engage with trustees and have an open and honest dialogue with them. If an employer is concerned about the potential impact of a corporate transaction on the scheme, they should talk to the trustees and, if necessary, consider applying for clearance. Clearance is and will remain voluntary – however, we do expect both parties to be able to recognise the types of situation that give rise to risks to members, and to contact us if they have concerns.

We have recently voiced our concerns around the potential for pre-pack insolvencies to be used as a vehicle to offload pension liabilities quickly and cheaply. Where we become aware of this type of arrangement, we stand ready to investigate and will carefully consider the impact on the pension scheme and how the situation has come about.

All parties must remember that any employer insolvency crystallises members' benefits and that if schemes are underfunded members will potentially receive a lesser pension payout than promised. This will also be a greater burden on other PPF levy payers – who pick up the bill via increases in the levy.

Further clarity around case work

Over the past year, as well as continuing to publish the determination notices issued by the Determinations Panel, we have also published a number of 'section 89 reports' covering other aspects of our regulatory casework. These actions aim to increase clarity around our actions and our decisions relating to cases.

The section 89 reports help us explain more to the industry about the rationale behind some of our key cases, including instances where we have used our powers. Over time we expect trustees to learn from the reports we publish and to use this knowledge to inform the difficult situations and decisions we know they face.

As well as aiming to provide information about our decisions in specific cases, we will also continue to increase the clarity and transparency of our processes. We are currently consulting with the industry on the procedures that our case teams follow as they bring a case to the regulator's Determinations Panel. Alongside this the Determinations Panel are also consulting on an updated version of the procedures it follows for making a determination on a case. We hope that each of these moves will help both trustees and employers to better understand how we work and the consultations both run until the end of June.

Looking ahead

We are taking a more segmented approach to regulation and will proactively engage with those schemes where we believe there is greatest risk to member benefits and PPF levy payers, based upon experiences of previous funding cycles. Schemes in a stronger position can expect less intervention by us, but we will place more focus on schemes in a weaker position. In those rare situations where the sponsoring employer is so weak that trustees are not able to put together a viable plan, we urge them to contact us as early as possible in the process.

Later in the year, we also intend to set out our strategy on how we will evolve our regulation of the DB landscape in the coming years.

We recognise the demands on trustees, and the levels of knowledge and understanding they need, can be extensive. We also appreciate that the current economic conditions are adding to those pressures. We are sensitive to these difficulties, but we also have a duty to make sure that high standards are met. In that regard, we are committed to providing as much support and information as we can, and always welcome your thoughts on what more we can do.

Stephen Soper
Executive Director for Defined Benefit Funding at the Pensions Regulator

News from The Pensions Archive

Based on experience gained from working with various pension schemes The Pensions Archive Trust has published a new Archival Policy Guide for Pension Trustees and Managers. The Archival Policy Guide is intended as a reference source for pension trustees and managers, with advice on how to manage the records created and maintained in the course of administering a pension scheme and guidance on how any material that would be worthy of long term preservation in an archive should be handled. The guide is available on The Pensions Archive Trust's website at: www.pensionsarchive.org/guide

Printed copies are also available from Katy Johnson, the Trust's Archivist, who produced the guide. She can be contacted at:
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City of London:
London Metropolitan Archives
40 Northampton Road
London EC1R 0HB
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The Archival Policy Guide forms part of the Trust's efforts to promote the importance of preserving pension scheme records amongst those involved in the operation of schemes, and providing advice and guidance on how they can safeguard their archival material.

Although the Archival Policy Guide focuses on pension scheme records, the advice it provides applies equally for records produced by professional bodies, service providers or other organisations in the pensions sector, so it is hoped that these organisations will also make use of the guide.

Malcolm Deering, our volunteer, continues to make good progress with the Research Guide to LMA pension related material. He has searched over 3,500 LMA collections and has uncovered 770 collections which have material relating to provision for old age in various forms. He has written an article on his experiences since becoming a volunteer last year which can be found on the website. If there are others who would be interested in becoming a volunteer do contact Katy Johnson.

The Trust is also keen to encourage those involved in pensions to visit the Pensions Archive. Tours and present-ations on the work of the Archive can be arranged through the Archivist. The Executive Committee of PRAG recently held one of its meetings there and was given a presentation on the Trust's work. PRAG is one of the Trust's original funders as well as a depositor of material. The NAPF South East Group is also planning to hold its Autumn meeting there.

The Trust has now been running the Pensions Archive in conjunction with the London Metropolitan Archive for over five years. It has drawn up a Strategy Plan setting out its aims for the coming five years.

However, we can only fulfill that strategy if we have the funding to make it possible. We are entirely reliant on charitable donations, in particular from organizations connected with the pensions business. We have no financial support from any other body.

We are enormously grateful for the sponsorship received so far but are now at the point where new commitments are needed if the Trust's work is to be able to continue.

Our requirement is relatively modest, particularly when spread across a number of sponsors: some £50,000 per annum will enable us to continue to fund the employment of our dedicated Archivist and go towards achieving some of our other ambitions, too. While commitments of funding over a three or five year period from pensions-related organizations will help us to plan ahead, one-off donations as well as Gift Aid donations from individuals are also most welcome.

Remember, as someone involved with pensions, this is 'your' archive. Do please consider if you or your organis-ation can possibly help. As one of our supporters pointed out recently, people may not always learn from history, but they deserve to have the opportunity to do so. Every contrib-ution, at whatever level, is vital to our goal of ensuring that this opportunity continues. If you are able to help I shall be very pleased to hear from you.

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Comment

Accelerated Rectification

Lesley Browning *Partner, Norton Rose LLP*

Introduction

Norton Rose LLP acted for Industrial Acoustics Company Limited (the Company) in a rectification case where equalisation of normal retirement dates (NRDs) of a pension scheme was inadvertently reversed by subsequent scheme documents. The High Court heard the case relating to the Industrial Acoustics Limited Retirement Benefits Scheme (the Scheme) in May 2012.

The Company managed to obtain the order for rectification in a tight time frame. The order was made seven months from the date the error was discovered or, put another way, just eight weeks after legal proceedings were issued by the Company. Typically it might take around two or more years to complete a rectification case. Few pension cases have been suitable for rectification by way of summary judgment and it is rare for these types of cases to be dealt with on an expedited basis, indeed, as far as we are aware, it may be unprecedented. This case therefore highlights the possibility, for suitable cases, of obtaining rectification extremely quickly. It also provides a useful summary of the legal principles applicable to the rectification of pension scheme documents.

The Claim

The Company sought rectification of the provisions of the Scheme rules relating to NRDs. Initially, the Scheme's NRD was age 65 for men and age 60 for women. Following the European Court of Justice's decision in Barber v Guardian Royal Exchange in 1990, NRDs under the Scheme were equalised in two stages. In 1991, the Scheme was amended so that NRD for new joiners became age 65. In 1995, after the clarification of uncertainties stemming from the Barber judgment, a resolution was passed by the Company to alter NRDs to age 65 for all members of the Scheme who had joined before 17 May 1990. However, in 1998 and 1999 two separate resolutions were entered into which undermined the effect of the change made in 1995 for pre 1990 joiners. The 1998 and 1999 documents mistakenly defined the NRD of female members as age 60. These errors reversed the effect of the resolution made in 1995, which was not the intention of the Company. To complicate matters, the Company was also the sole trustee of the Scheme at the time.

At all times after the 1995 resolution was passed, the Scheme was administered on the basis that the 1995 resolution was effective, such that NRD was age 65 for all members. There were numerous documents, such as actuarial valuations, evidencing this. The Scheme continued to operate on the basis that equalisation had been effected for all members until the error in the documentation was discovered in October 2011.

It was quite clear from the contemporaneous documents and from the witnesses that we were able to interview that the changes in 1998 and 1999 where not introduced to reverse the equalisation achieved in 1995. As such, the case was suitable for summary judgment, meaning that a full hearing, in which witness evidence would be heard before the judge, was not required. To seek summary judgment on a pensions matter an applicant needs to be able to establish that there is no real prospect of the members being able to successfully oppose the application for rectification (the trustees typically adopt a neutral approach, as their main duty is to administer a scheme on its correct terms) or there is no other compelling reason why the case should be disposed of at a full hearing. The Company decided that summary judgment would be sought. The application for summary judgment was unopposed by the respondents, who were the current trustees and a representative beneficiary of the Scheme, both parties having the benefit of legal advice from solicitors and counsel.

Timing / Expedition

The errors were first discovered because the shareholders of the Company wanted to put the Company up for sale. Before doing so, they carried out an internal review of the scheme documents. The existence of the errors, and the uncertainty of their impact on Scheme funding, played a part in the first preferred bidder identified by the shareholders not proceeding with the transaction. A new preferred bidder was later identified and to avoid jeopardising the sale, the Company made every effort to resolve the issue as quickly as possible. The Company's desire to protect the sale process and meet with the preferred bidder's timeline for the transaction formed the basis of the application for expedition.

The Company needed to review all relevant documentation and to contact relevant witnesses (for example, Company representatives and advisers) in order to prepare its case. Given the fact that the events took place some 17 years previously, the Company was fortunate that it had some excellent witnesses with good recollection of the equalisation process. The Company issued an application for summary judgment and for an order seeking to expedite the summary judgment application. Expedition allows a case to "jump the queue" in the list of cases waiting to be heard by the Court. Expedition is entirely at the discretion of the judge who hears the expedition application. The judge needs to be persuaded that the matter is indeed urgent, as the interests of the third parties, with pending cases which would be leap-frogged, also need to be taken into account.

It was necessary to have an initial hearing to request the Court to grant expedition. The Court considered the legal principles relating to expedition as summarised in CPC Group Limited v Qatari Diar Real Estate Investment Company. The principles state as follows:

- the issue as to whether to grant expedition, and on what terms, is essentially a matter for the discretion of the judge;
- like any discretion, it must be exercised judicially and is partly a question of principle and partly a question of practice;
- the general principle is that cases are to be brought to Court as soon as reasonably possible;
- the procedural history of the claim is a factor to be taken into account and delay may count against the applicant;
- the Court must balance the need for expedition against the wider requirement of other litigants to have their cases heard and for that reason, objective urgency must be demonstrated; and
- a respondent's attitude is only of importance if real prejudice will be caused by expedition.

Having considered these principles, the Court held that the case was suitable for expedition because of the sale process relating to the Company. The judge was satisfied that the Company had acted without delay and the Company was assisted by the fact that the trustees and representative beneficiary did not object to the expedition application.

Rectification- Legal Principles

The summary judgment hearing was subsequently held some two weeks after the expedition hearing. The hearing involved considerable debate about the legal basis for the rectification of the Scheme. The judge acknowledged that whilst he would not make any novel interpretation of the law concerning rectification, it was necessary for him to consider the recent case law concerning the position of a rectification claim as applied to a pension scheme. The Court considered a number of rectification cases, including Swainland Builders Ltd v Freehold Properties Ltd, Scania v Wager, Chartbrook v Persimmon, Colorcon v Huckell and Daventry District Council v Daventry & District Housing Limited. It was recognised that there was some uncertainty in the previous authorities (not all of which related to pension schemes) as to the precise test needed to determine the common interest of the parties.

The judge applied the legal test of rectification in Daventry District Council v Daventry & District Housing Limited. The test in that case requires that:

- the Company and trustees must have had a continuing common intention at all times after the resolution effecting equalisation was passed in 1995 that it should continue to apply;
- the continuing common intention existed at the time of execution of the documents in 1998 and 1999 which the Company sought to be rectified;
- the objective observer would have no doubt, after looking at the actions after the execution of the documents in 1998 and 1999, that the continuing common intention prevailed and that it had been the intention of the Company and trustees that the resolution passed in 1995 remain effective, irrespective of the mistakes made in relation to the 1998 and 1999 documents; and
- the mistakes in the 1998 and 1999 documents did not reflect that continuing common intention.

Accordingly, the judge found that the continuing common intention had prevailed when the subsequent documentation was executed in both 1998 and 1999 and indeed up until the present day. As a result, rectification of NRDs was both warranted and justified.

Position of Scheme Members

The judge noted that there was no legal requirement to notify all members of a pension scheme that a rectification claim was being brought (provided that there was an appropriately appointed representative beneficiary to act on their behalf). However, a practical point to note is that the judge considered that it was preferable to notify all members in any event. In the case of the Scheme, every possible step had been taken to ensure that the representative beneficiary had access to all relevant materials, that his counsel and solicitors had considered in detail. Therefore, it could not realistically be argued that another member of the Scheme, who was unaware of the rectification claim, would find an argument that had not already been promulgated. The members had not been notified by the Company or the trustees of the application and in further cases it might be prudent to notify the members when proceedings are issued. This would avoid any risk of a judge feeling either that the position of members had not been taken into account, or that the Court should hear further argument from members.

Conclusion

The combination of expedition and summary judgment endorsed by the High Court in this case is a welcome development for pension schemes. The speed at which rectification was obtained resulted in reduced litigation costs to the Company and achieved the shareholders' commercial objective of readying the Company for sale. Of course, not all cases will be suitable for rectification in this manner. An obvious error will be required before summary judgment can be considered and to achieve expedition, some real urgency will need to be demonstrated. Nevertheless, this case is a useful precedent to consider where rectification of a clear mistake is needed.

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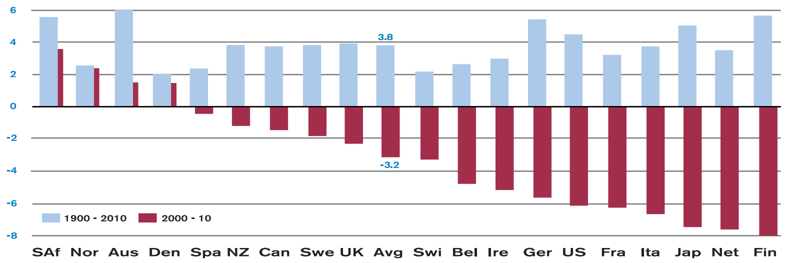
Comment

Between a rock and a hard place

What are investors to do when equities are not exactly undervalued but bonds are flashing warning lights?

Abi Oladimeji *Investment Strategist, Thomas Miller Investment Ltd*

Chart 1: Annualised excess returns of equities vs bonds (%)



Source: Credit Suisse Global Investment Returns Yearbook 2011. The Countries used in this chart are listed in the appendix.

A benign environment for government bonds

Just as the period from the early 1980s to the late 1990s was a golden era for equities, with much higher annualised returns than long term averages, the last 30 years have seen a confluence of events that have brought about a steady decline in inflation and interest rates. That resulted in a bull market for government bonds. For pension schemes, the decline in yields has resulted in substantial increases in the present value of liabilities.

Recent performance and medium-term outlook for government bonds

However if one measures returns, be it via absolute or risk-adjusted numbers, it is evident that equity returns have been subpar since the turn of the 21st century. Chart 1 compares the annualised difference in returns between equities and bonds (equity risk premium) for 19 countries over two time periods. The blue bars show annualised excess returns over the 111 years to 2010 while the red bars show annualised excess returns over the 11 years to 2010.

A number of observations can be made from Chart 1. First, while the long run return from investing in equities has been higher than bonds, this is what one would expect, given their higher risk. Indeed, across the 19 countries in the sample, the long term annualised equity premium versus bonds has been about 3.8%. Second, the 21st century has seen a marked deviation from the long term historical norm. Between 2000 and 2010, the average realised equity premium was -3.2%.

The authors of the Credit Suisse Global Investment Returns Yearbook note two alternative interpretations for this phenomenon. One is that the reward for investing in equities has simply disappeared. Alternatively, bonds have become expensive and investors should be wary of capital losses. They documented the scale of previous periods of protracted losses in bonds and equities. They noted that "historically, bond market drawdowns have been larger and/or longer than for equities". They stated that "government bonds have suffered two big bear markets, followed by recoveries. On both sides of the Atlantic, bonds were under-water in real terms for about half a century." They went on to point out that "the bad times for bond investors have included times that are inflat-ionary, and when interest rates are low and then subsequently rise more than expected." It is worth noting that while inflation remains muted, interest rates in the UK and US remain at all time lows. In light of the high levels of government debt in the UK and across the developed economies, the temptation for governments to monetise debt may yet prove too strong. Beyond the current period of economic weakness, an extended period of higher than expected inflation may not be as unlikely as many investors assume.

Return-free risk?

The return on bonds can be decomposed into two components: current yield and capital gain. Despite brief periods when safe haven demand has pushed nominal bond yields into negative territory (a case in point being the 2-year German Bund which recently traded on negative yield for a brief intraday period), nominal bond yields should not go below zero for any sustained period of time. Consequently, it follows that the potential for further capital gains diminishes as yields decline. Given how far yields have fallen in the UK and elsewhere, it is clear that the potential for further capital gains from government bonds is now severely limited.

A sizeable portion of total returns earned in government bonds over the past 30 years has been in the form of capital gains. That was only possible due to the prevalence of a high yield environment at the beginning of the period followed by a protracted decline in yields. As nominal yields drop closer to that zero bound, government bonds offer little reward for the risk involved. Looking to the next 10 years, the risks are clearly skewed in the direction of capital losses. In the absence of capital gains (and if one made the optimistic assumption of no capital losses in nominal terms over the next 10+ years), the only return from government bonds will be coupon income. In most cases, that income will struggle to match inflation, resulting in a decimation of invested capital over time.

Mitigating factors

It is worth noting that while the outlook for government bonds for the long term investor is not particularly

Appendix:
SAf - South Africa, Nor - Norway, Aus - Australia, Den - Denmark, Spa - Spain, NZ - New Zealand, Can - Canada, Swe - Sweden, UK - United Kingdom, Swi - Switzerland, Bel - Belgium, Ire - Ireland, Ger - Germany, US - United States of America, Fra - France, Ita - Italy, Jap - Japan, Net - Netherlands, Fin - Finland

attractive, a number of factors may continue to hold down bond yields for some time. In the short term, while the global economy remains moribund, extraordinary central bank response, in particular quantitative easing, will remain on the agenda. That may well drive yields lower in the short term. More significantly, demographic changes may mean a substantial increase in demand for bonds as Western populations age. This pool of demand may limit the upside in bond yields in the years ahead.

While acknowledging that the expectation for future bond returns to be lower than in the "golden era" does not imply that bonds will enter a protracted period of negative performance, the authors of the Credit Suisse Global Investment Returns Yearbook stated that:
"…the golden age of the last 28 years cannot continue indefinitely, and we must expect returns to revert towards the mean. Only a raging optimist would believe that, given today's bond yields, the future can resemble the more recent past. It is sheer fantasy to expect bond performance to match the period since 1982."

At this point, the words of the late American investment banker Shelby Cullom Davies have a certain resonance: "Bonds promoted as offering risk-free returns are now priced to deliver return-free risk."

Are equities undervalued?

On the basis of current valuations, it would seem that equities offer better long term value than bonds. For instance, on dividend yields of about 3.8% and 2.4% respectively, the FTSE All Share and the S&P 500 indices hardly need to deliver stellar capital growth in order to comfortably exceed the potential return from respective government bonds. Consequently, for many investors, the argument that government bonds do not currently offer an attractive risk-reward trade-off is automatically taken to imply that equities are by extension the place to be. However, the case is not quite as clear cut.

The table below, taken from a recent paper by Peng Chen of Ibbotson Associates, presents annualised returns for the S&P 500 index and three US bond indices.

As shown in the table, Ibbotson Associates' calculations of historical long run equity returns (1926–2010) is 9.87%. In contrast, long term returns on the Ibbotson US Long Term Government bond index is 5.48%. These numbers help to put the more recent performance of both asset classes in some context. For bonds, the message is clear: performance over each of the sub periods shown has been better and quite often, substantially better than the long term average. Additionally, over 5, 10, 20 and 30 years, return from bonds have either bettered or virtually matched returns from riskier equities.

For equities, the message needs some interpretation. Despite delivering worse risk-adjusted returns than bonds for several sub-periods shown in the table, equities have nevertheless matched or outperformed their long term average return during most of the sub-periods. Only over the 5 and 10-year sub periods have equities significantly underperformed their long term average.

This evidence may be interpreted as suggesting that the poor returns from equities over the past decade have not been inconsistent with the risk profile of the asset class. Indeed, it suggests that the poor returns from the last decade were merely a reversion to the long term average and a correction of the atypically high equity returns from the preceding two decades.

Moreover, reliable measures of long term stock market value such as q-ratio and cyclically adjusted price-earnings ratio (CAPE) actually point to continuing overvaluation in equities. Smithers & Co provides a regular update of both measures. The numbers show that quoted shares, including financials, were overvalued by 50% according to CAPE and US non-financials were overvalued by 41% according to q as at 8th June 2012. They note that "although the overvaluation of the stock market is well short of the extremes reached at the year ends of 1929 and 1999, it has reached the other previous peaks of 1906, 1936 and 1968."

A multi-asset class approach may offer a solution

So where does the foregoing leave investors who are faced with an asset allocation decision between bonds and equities? Baring very specific considerations (e.g. tax) investors should not have an inherent preference for any particular asset class. Once this view is taken on board, a multi-asset approach may offer a useful solution. The key here is to avoid a bias in favour of any one asset class and instead maintain the tactical flexibility to regularly alter allocations between a broad range of asset classes as market and economic conditions dictate. A well designed multi-asset class investment strategy should not emphasise returns over risk management. On the contrary, it should focus on delivering superior risk-adjusted returns over the economic cycle.

Table 1: Compound Annualised Total Returns (Ending December 2010)

Span and Start Date	S&P 500	BarCap U.S. Aggregate	Ibbotson U.S. Intermediate - Term Government	Ibbotson U.S. Long - Term Government
1 Year: Jan 2010	15.06%	6.54%	7.12%	10.14%
5 Years Jan 2006	2.29	5.80	6.06	5.58
10 Years Jan 2001	1.41	5.84	5.64	6.64
20 Years Jan 1991	9.14	6.89	6.56	8.44
30 Years Jan 1981	10.71	8.92	8.51	10.18
40 Years Jan 1971	10.41	8.32	7.81	8.57
Jan 1926 Dec 2010	9.87	–	5.35	5.48

The BarCap U.S. Aggregate goes back only to January 1976.
Source: P. Chen. 2012. "Will Bonds Outperform Stocks over the Long Run? Not likely", Ibbotson Associates.

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Source references:
1. Elroy Dimson, Paul Marsh, and Mike Staunton (2011), "Credit Suisse Global Investment Returns Yearbook".
2. Peng Chen. 2012. "Will Bonds Outperform Stocks over the Long Run? Not Likely", Ibbotson Associates.

2012 Annual Pension Risk Conference

Chairman's comment

OPDU's Annual Risk Conference was held in March at Centrepoint.

As OPDU is focused on providing protection for trustees, this Conference examined the risks to which trustees are exposed and how to manage them.

Given the state of the world economy and markets, the theme of the conference **"Managing Trustee Risk in Volatile Times"** was particularly appropriate. Our keynote speaker, Sharon Bell, Vice President, European Portfolio Strategy Team, Goldman Sachs, gave a wide ranging and stimulating presentation on the volatility of equity markets, the low bond yield world and the current economic uncertainty and associated risks for pension funds.

The biggest single risk that defined benefit (DB) schemes face is covenant risk and Graham Wardle, Managing Director of BESTrustees plc, looked at how trustees can manage covenant risk and gave key monitoring and governance tips.

Given that most DB schemes are closed, at least to new members and increasingly to future accrual, the strains which volatile funding levels are imposing on sponsoring companies and schemes alike, mean it is inevitable that conflicts are going to arise, especially given the different priorities of company directors and scheme trustees. Dan Schaffer, a partner at Herbert Smith LLP, gave some pointers on how best to handle such difficult situations.

There are a variety of ways in which trustees can manage investment risk. One strategy is for trustees to delegate many of their investment decisions to experienced "Fiduciary Managers" or "Implemented Consulting" firms. The pros and cons of this approach were debated between Ian Bailey of AON Hewitt, Gavin Orpin of Lane Clark and Peacock and John Heskett of AllenbridgeEpic Investment Advisers.

Volatile markets pose much greater risks for members of defined contribution (DC) schemes and also for trustees of such schemes. Many people are questioning whether current DC scheme design is fit for purpose given that, for most people, only DC benefits will be available in the future. Chris Hitchen, a Trustee Member of NEST, and Morten Nilsson, CEO of NOW:Pensions, debated the question – "DC - is it time for a rethink?"

The Conference finished by looking at how trustees can deal with situations where things are going wrong and how to minimise the risk of getting into difficulty. Tony King gave a presentation on "How to avoid the Pensions Ombudsman" and Charles Magoffin and Dawn Heath of Freshfields Bruckhaus Deringer LLP told us "Ten things you may not know about Trustee Liability".

Most of this edition of "The **OPDU** Report" is devoted to articles by our Conference speakers. I hope you will find them informative and useful. As I write this article, gilt yields are close to record lows with serious consequences for DB scheme funding levels and annuity rates for retiring members of DC schemes. Furthermore, the consequences of the Greek General Election and the Spanish banking crisis are raising serious concerns about the future of the Euro. There will be plenty to talk about at next year's **OPDU** Pension Risk Conference. I look forward to seeing you there.

Peter Murray
Chairman
OPDU Advisory Council

2012 Annual Pension Risk Conference

The OPDU/ACE 2012 Annual Pension Risk Conference: "Managing Trustee Risk in Volatile Times"

In accordance with **OPDU**'s aims of helping to raise standards of trusteeship and pension scheme management, we were pleased to jointly host the Conference with our underwriters, ACE European Group Limited, at no charge to delegates.

Trustees and those involved in running defined benefit and defined contribution pension schemes have to manage many potential risks.

The Conference focused on key risks including: economic risk,covenant risk and separation of interests of the company from those of the trustee, managing investment risks for both defined benefit and defined contribution schemes, trustee liability, and the powers of the courts, ombudsman and regulators. The Conference was very well attended which reflected the calibre of speakers and the topical content of the programme.

The feedback also confirmed that the panel discussions, which were factored in throughout the day gave ample opportunity for questions.

An online version of the Delegate Pack provided on the day, including speaker's presentations, is available for viewing and and you can also download a copy titled **Review of 2012 OPDU Annual Meeting** from the home page under **News on the Bulletin Board** at **ww.opdu.com**

(Due to the size of the PDF file it may take a few moments to download.)

Subjects for future conferences

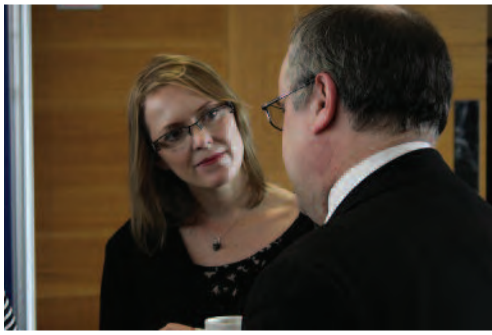
We would be pleased to consider your suggestions of subject matter and/or speakers for future conferences.

(Follow the above link on the website)









"This one of the best conferences in the Pensions Calendar"

"Excellent mix of speakers and content"

"One of the best conferences that I have attended"

"Extremely interesting and informative"

Pension Schemes: The economic and investment risks in perspective

Sharon Bell *Vice President, European Portfolio Strategy Team, Goldman Sachs*

Equities: Risky but cheap

Stocks and shares have provided excellent long-run returns. Going back 40 years, the UK market is up seven-fold in real terms which is an annual rate of 5.1% – both figures include dividends and assume these are reinvested.

But we all know that equities are also very risky and that for the last decade (not exactly a short period of time!) returns have been weak and, depending on your starting point for investment, in some cases negative. Since the peak for the UK market at the end of 1999, the FTSE 100 is down 19%.

Indeed we find that even over the medium term, say three years, you've got to be pretty brave to invest a lot in shares. The chances of losing money on your investment if you invest in the equity market over three years are about one in four (this is based on the last 40 years of data). This you might think this is a reasonable chance but obviously no one wants to lose money invested. Also more worryingly you've even got a one in six chance of losing more than 10% of your investment.

Equities are volatile and risky even assuming you hold them over a two- or three-year horizon. But because of recent performance, share prices are still low relative to the last decade and we think the price or valuation of shares is important for assessing how risky they genuinely are; it's an obvious statement but you want to buy something when it's cheap.

Back in 1999 things looked good. The market had almost doubled in value over the previous decade, GDP growth was strong and a wave of exciting new technology companies had listed on the market.

But equity prices were very high. Comparing Price to Earnings, the P/E ratio, the UK market was trading on 21x when a more typical long-term P/E ratio has been around 12x.

Today the market is on a P/E ratio of closer to 10, lower than the average over time. We don't doubt that the risks are high; fiscal austerity is hitting economies across Europe hard, unemployment is high and is proving difficult to solve and there are still lingering concerns about the indebtedness levels of European governments. However, these risks are in our view well reflected in the current relatively low price for equities.

We believe equities are especially good value compared with bonds. We all know about the low annuity rates available at the moment which are a reflection of the super-low yield currently available in the bond market. UK 10-year gilts are yielding just over 2%. The average yield over the past 10 years has been 4.2%. Part of the reason for this is that the Bank of England has been buying gilts in order to inject cash into the economy and keep long-term borrowing costs low. But it means that returns for savers and investors are very poor. The dividend yield on the UK equity market, currently around 3.4%, is higher than the yield on bonds.

The perfect storm

For pension funds, the last decade has been especially tough. Equity returns have been low or worse still negative. And the present value of future pension liabilities has risen with the falls in bond yields. Assets down, liabilities up; the perfect storm.

But surely bond yields falling should have been great news for equities. Investing in a company's shares is just investing in all their future cash flows (or more specifically dividends as this is the only bit returned to you). If bonds yields are low, surely all those future cash flows I'm going to receive are worth more today; the discount rate has gone down. But unfortunately falling bond yields are largely a reflection of lower expected economic growth rates and higher risk aversion, meaning people want the safety of government debt and are willing to invest in it even if it pays them very little.

Weak economic growth and high levels of aversion to risk are both bad for share prices. We find there is an interesting dynamic relationship between bond yields and equities. When long-term bond yields are above 4% or 5% (remember the days!), then yet higher bond yields are bad news for equities as it's a signal that inflation risks are rising and the central banks will most likely have to raise interest rates and the economy will slow. The 1970s is the best example of this. The equity market in these circumstances prefers bond yields to be coming down as it's a signal inflation is coming back under control. We had this through most of the 1980s – falling bond yields and a rising equity market. But when bond yields are below 4% or 5%, the opposite is true. Falling bond yields are no longer a signal that inflation is under control; instead, they suggest the risk of deflation (as in Japan) or at the very least low economic growth.

Bond yields are currently very low and we think that modest rises in bond yields from these levels would be good for equities and good for pension funds, as it means a higher discount rate for liabilities. Basically we're saying we've been through the perfect storm with bond yields falling and equities collapsing, but it could easily reverse. As bond yields rise, because people eventually become more confident in growth, the equity market can do well.

Three risks

I want to focus on three risks which I think are particularly interesting and topical:

1. The debt burden in Europe

2. Growth divergence

3. Competition from China

1) The euro area debt problem

The first one has certainly received a lot of focus in recent months but is there a real problem? Or can Euro area countries solve their debt problems gradually and relatively painlessly over time?

Our economists forecast that debt as a percentage of GDP is likely to continue to rise in Italy and France until 2013/14, to just below 125% and 95%, respectively, but then decline fairly rapidly thereafter. Spain on our estimates should see its debt-to-GDP ratio rise to a lower level at just over 80%, but see no subsequent rapid debt reduction. The primary balance requirement to reach a 60% debt-to-GDP target 20 years after debt peaks is around 4.5%-6.5% for Italy, 1.5%-3% for France and 2.5%-3.5% for Spain on our estimates. The primary balance is the amount of government revenues (taxes) minus current expenditure, so it doesn't include the monies necessary to make interest payments. While current fiscal plans suggest Italy and France are broadly on track, Spain will likely need additional austerity, in our view.

But what does on track mean? Well it assumes that countries can finance their debt burdens at reasonable interest rates, that they commit to all their austerity plans and that their economies also grow at a reasonable pace. We don't think any of the assumptions are especially unrealistic, for example we assume a trend real economic growth rate in Italy of just 1.5% pa, but there is clearly a risk that all these things don't happen, or turn out worse then we expect. If for example Italy has weaker growth than we expect, or interest rates stay high or that the fiscal program is not enforced, then debt may not come down and could easily get higher. We think that debt levels in Europe ultimately will come down to more sustainable levels and the good news for Italy is that while it has a high legacy of debt, it also has a strong budget position now and structural reforms should improve long-term growth.

2) Divergence in growth

Another risk I want to discuss is the divergence in growth globally. Now in some ways I've wrongly named this as a risk because it is also an opportunity. In 2012 we estimate that globally GDP will grow at 3.5%. Not bad. But nearly all of that growth, 2.2% points worth, is coming from the fast growing and large BRICs economies (Brazil, Russia, India and China). These account for 64% of all world growth.

This is great news if you are a business with opportunities to invest in that region. But it also creates plenty of its own risks. If these economies slow, it will be painful for everyone as the world is so dependent on growth from these nations. In addition, the fast pace of growth in these countries, and especially the rapid industrialisation, has meant a high demand for the world's resources. Commodity prices have generally risen in recent years and look set to rise further in the next few years. This creates extra pressures on the developed countries where the cost of living is rising at the same time as wages are flat or rising only slightly.

3) Competition from China

Lots of European and UK companies sell into China very successfully and many of these are listed on the stock exchange. But also many Chinese companies compete for business in the West. This of course is the essence of global trade and economists would argue that all countries should gain. But for individual businesses, competition from Chinese manufacturers may pose a threat.

Chinese companies used to be focused on the low-cost end of the market. It's not surprising that Europe has a trade deficit with China in apparel and textiles and has done for the last decade. But China has been moving up the value chain. Europe has recently moved into a trade deficit with China in areas such as Telecom equipment for example. At the moment, Europe still has a surplus in cars and specialist machinery but these are areas Chinese companies could look to target over the next decade.

In the UK, around one-quarter of all new degrees are in the fields of science and engineering (similar to the average for the G7 nations); in China 40% of degrees are in this field. In addition, the Chinese government's current 5-year plan is to focus investment in higher technology areas such as aerospace, computer chip design and manufacture and IT.

Timeline for European industries and their exposure to China competition

Rough time line	Industries exposed
- 5 to 10 years	Commodity chemicals Speciality chemicals Telecom Equipment
- 2 to 5 years	Solar cells Telecom Handsets
Now	Power transmission and T&D (low end) High speed rail
+ 2 years	Wind power generation SmartGrid technologies API (active phamaceutical ingredient) Solar equipment machinery
+ 5 years	Civil aircraft Agri-chemicals IT services Generic pharmaceuticals Power transmission and T&D
+ 10 years	Civil aero engines Software Vendors Autos
+ 20 years	Med tech: Implantable devices
+ 30 years	Industrial gases Pharmaceuticals - new drugs

So risks abound but equally so do opportunities and in our view asset markets (both bonds and equities) are a little too focused at the moment on the risks and not enough on the opportunities – the opposite of what was the case in the last 1990s technology bubble.

We show in the table which industries could see more Chinese competition and over what type of time scale, these industries and rough time line were derived from discussions with our company analysts in Europe and China. Of course China is a threat and an opportunity: European companies often form partnerships with Chinese companies and European companies have been successful at selling into the growing middle class in China and other fast-developing countries. Indeed, we regard the growth of the BRICs countries as hugely important in helping to kick-start Europe's growth by providing potentially fast-growing export markets.

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Covenant:

How trustees can manage covenant risk

Graham Wardle *Managing Director, BESTrustees plc*

"Employers should provide trustees with the information they or their professional advisers reasonably require to assess and monitor covenant".

A Scheme's technical provisions are met by the assets held and the recovery plan in place. However, without the backing of the employer a self-sufficiency level of funding would be required. The difference between the self-sufficiency funding level and the technical provisions is the amount which needs to be supported by the employer covenant.

The employer also underwrites the risks the Scheme is running, the main ones being the underfunding risk, the investment risk, the longevity risk and the inflation risk.

It is therefore important for trustees to assess the strength of that covenant. In order to do so trustees need information from the employer and in recognition of this the Pensions Regulator included the following in its guide for employers of June 2010. This is a statutory obligation on employers but as some of the information the trustees will need is almost certainly confidential, it is perfectly reasonable for employers to insist that trustees enter into a confidentiality agreement before releasing it.

The Pensions Regulator used to define covenant as the employer's ability and willingness to pay. The problem with that definition is that "willingness" is subjective. Management and corporate structures can change, which could result in the employer becoming less willing. In any event what value are assurances that are not legally binding given that they don't protect the position of the Scheme?

In recognition of this the new definition of covenant is the employer's legal obligation and ability to fund the scheme now and in the future. Note the reference to the future; covenant assessments need to be forward looking. Just because an employer's covenant has been rated as strong in the past does not mean it will continue to be so. Note also the reference to legal obligation; this is a reason behind the Regulator's recent requirement on all schemes to identify their statutory employers.

Trustees need a framework for assessing, reviewing and monitoring covenant. It is just as important to the security of the Scheme as monitoring investment performance, although historically much less time has been spent on it. The past is helpful but it is the forecast of future performance of the employer which is more important.

So when and how should trustees assess, review and monitor covenant?

Typically trustees assess covenant in conjunction with the periodic actuarial valuation, which is normally carried out every three years. A question that needs to be addressed is do the trustees need to have an external covenant assessment carried out? The answer is, it depends! If the employer's business is straightforward and/or if the trustee body has sufficient skills it may not be necessary.

Whatever the decision it is important for trustees to agree what they are looking for, otherwise they may end up spending a lot of money on a report which tells them things they already know! There are examples of just that happening, particularly in the early days of the covenant assessment industry.

Probably the most important things the trustees need are an assessment of overall covenant strength and a view on how much the employer can reasonably afford. Both of these assessments should be current and forward looking.

It is also important that trustees act proportionately in assessing covenant. If it is obvious that the covenant is weak, for example if the Scheme has a large deficit and is much bigger than the company or if the company is unprofitable with a weak balance sheet, then probably not a lot of work is needed. In the same way (but a much better position for trustees) if the deficit on a Section 75 basis is significantly less than the assets that would be available to the trustees on insolvency or if a short recovery period has been agreed then less work is needed.

If, having done the assessment, trustees conclude that some improvement to covenant is needed and cash is not available, then trustees should look at the alternatives. A contingent asset, such as a property, which would be passed to the scheme in the event of a contingency such as failure to make agreed payments or insolvency are worth investigating. Other possibilities include parental guarantees or escrow accounts.

Non cash transfers have also become increasingly popular. Typically this would be a special purpose vehicle structured as a pensions funding partnership between the employer and the Scheme. The partnership acquires assets from the employer and the Scheme receives income from that partnership during its lifetime and possibly a variable capital sum at the end of its lifetime. The value of the investment in the partnership reduces the deficit by that amount on day one. There are also tax advantages to the employer and security advantages to the scheme. So it is potentially a win-win arrangement. However, the cost of setting up these arrangements, in legal and consulting fees, can be eye-watering. As a result this route has tended only to be used by large schemes. Originally the assets placed in the partnerships were tangible ones (often real estate) but increasingly intellectual property is used although that should require a greater degree of overcollateralisation because if the employer is in trouble, the value of its brands may well be seriously reduced.

Trustees must then review the covenant. This should be done at least annually when the company's financial results are known. Typically a company representative would give a presentation to the trustees. The purpose is to assess whether there has been any material change since the covenant assessment was carried out, which will be a matter of judgement.

On a more regular basis, the trustees should monitor what is happening to the covenant which should be a standing item on trustee meeting agendas. To do this, trustees should agree an information protocol with the company. The information to be supplied might include management accounts, key performance metrics and comments on growing/declining business areas. D&B scores and information from credit rating agencies can also be useful. Trustees should also be aware of possible warning signs such as refinancing of debt on worse terms, payment of special dividends and interdependency between group companies.

So, to summarise, assess covenant strength in a proportionate way:

- Look at alternatives to cash funding if cash is not available
- Review covenant at least annually
- Monitor covenant as a standing item
- Be alert to changes which may require action.

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Managing conflicts:

How should sponsoring employer directors who are DB scheme trustees manage their conflicts of interest?

Dan Schaffer *Partner and Head of Pensions, Herbert Smith LLP*

Pete Townsend
gave us the answer.

"Ever since I was a young boy,
I've played the silver ball.
From Soho down to Brighton
I must have played them all.
But I ain't seen nothing like him
In any amusement hall
That deaf dumb and blind kid
Sure plays a mean pinball!

How do you think he does it?
I don't know!
What makes him so good?

He ain't got no distractions
Can't hear those buzzers and bells,
Don't see lights a flashin'
Plays by sense of smell."

In those lyrics performed by The Who and famously by Elton John in the 1975 musical Tommy lie the two tenets for playing the conflicts game successfully. You can't have "distractions," and the absence of visible bright-line rules means that directors who are trustees and legal advisers are forced to play by intuition and by sense of smell.

The issue remains a practical one. In 2008, the Trustee GAAP Survey noted that 67% of FTSE-100 DB schemes have company directors (or former directors) as trustees. The Institute of Chartered Accountants in a technical release in 2007 indicated that there is no inherent problem with finance directors as trustees. I am not aware that the view has been formally retracted. Industry commentator, personality and Manchester City fan , Steve Mingle, has even gone as far as saying, "many companies are too nervous and weak-kneed about conflicts of interest. Don't deny trustees access to the most talented and capable people because of a possible conflict of interest. Have the finance director as a trustee." Indeed tPR in its Guidance on Conflicts of Interest states that, "the regulator recognises that it can be beneficial to appoint senior staff from the sponsoring employer as trustees."

I shall attempt in this piece to provide the definitive clarification of this issue that continues to perplex. My way in is through a case study. Imagine this (a classic scenario):

- The scheme trust deed provides for the company to appoint trustees

- The FD and the HR director plus two members of middle management are trustees. There are also three employee non-management trustees and one pensioner trustee

- The HR director is chairman of trustees
- The Trust deed provides: (a) a meeting quorum of four; (b) decisions by majority present; and (c) operation by sub-committee
- Each trustee has signed the register of conflicts
- The company makes a not overly generous funding proposal to deal with the valuation deficit
- The company asks for trustees' agreement to cease DB accrual
- At the trustees' meeting the FD and HR director declare their conflicts but participate in discussion
- Both say they have read tPR's Guidance (2008) and the Plan's conflicts policy, "understand conflicts", "have identified the conflict" and their experience at being impartial allows them to "evaluate and manage the conflict"
- Both the FD and the HR director were involved in formulating the company's proposals.

The case study raises six issues.

Issue 1: rule against potential conflicts

The FD and HR director by being appointed as trustees have immediately put themselves in a position of potential conflict. The first point to grasp is that there is a legal prohibition against accepting trusteeship if there is potential conflict. Note the word "potential". Note the word "prohibition". It is a very strict rule because it is intended to deter behaviour that could lead to problems. That said the prohibition is lifted if the persons with the potential conflict are authorised to act as trustees despite there being potential for conflict. So if the company wishes to use its power of appointment to appoint the FD and HR director as trustees, it should check that the provisions of the trust make it sufficiently clear that a person may act despite a potential conflict of fiduciary duties. They owe fiduciary duties to the scheme members. As directors they also owe fiduciary duties to their company. The current world of funding deficits and corporate activity brings potential for doing one's best for the economic interest of the corporate entity which is a commercial enterprise and one's best for the economic interest of a scheme member into conflict. The legal authority for the need to check the trust deed can be found at paragraph 124 of Sir Richard Scott V-C's judgment at the High Court stage of Edge v Pensions Ombudsman [1998] 2 All ER 547. So if you are reading this on the sofa on Saturday evening before Match of the Day and you are a director and trustee, make an note in your iphone to call your lawyer on Monday morning to identify for you where in your scheme's trust deed does it authorise you to have a potential conflict.

Issue 2: rule against actual conflicts - no inhibition

The rule above was about placing oneself into a position of potential conflict. There is then a delicate separate issue if the facts you are facing present an actual conflict. The first matter on which to reach a conclusion is whether there is in fact an actual conflict. Although you had half an eye on the television, you will have picked up in the case study that the company funding offer was not "overly" generous. It may well be nevertheless that the offer was generous, but not overly generous. It may also be that on closer due diligence the company actually plans to incentivise them to agree to a cessation of DB accrual. Whether there is an actual conflict requires a factual judgement of if, on the facts, the FD and HR director are inhibited from doing their best (given their individual personal knowledge) for the schemes' beneficiaries to reach the optimum position.

If either of them are inhibited from doing their best to reach the optimum position for members, then it is very doubtful legally that a trust deed can (or in practice ever does purport to) provide immunity from the duty not to have an actual conflict of fiduciary duties. Support for this doubt can be found in both the House of Lords and Court of Appeal respective decisions in Hilton (Appellant) v. Barker Booth and Eastwood (a firm) (Respondents) [2005] UKHL 8 and Bristol & West Building Soc v Mothew [1998] Ch 1.

We will come on to what the directors should do in this instance in issue 6 but first we must deal with the tricky issue of knowledge. To this we turn next.

Issue 3: Are the FD and HR director required to share the knowledge they acquire as company directors with co-trustees?

The next concern for our FD and HR director is that there is a duty as trustee to share confidential information obtained as company directors with co-trustees that would aid their decision-making. The problem is that this will conflict with their directors' duty not to disclose such information. What is the legal position if the company should not waive that confidentiality? Does the trustee duty to disclose to co-trustees override the director's duty to the company not to disclose? The answer to this question lies in the House of Lords decision in Hilton v Barker (2005): neither duty trumps (i.e. overrides) the other. This case involved a solicitor (a fiduciary) acting for two parties. What their Lordships said was this:

"A solicitor who has conflicting duties to two clients may not prefer one to another… Since he may not prefer one duty to another, he must perform both as best he can. This may involve performing one duty to the letter of the obligation, and paying compensation for his failure to perform the other. But in any case the fact that he has chosen to put himself in an impossible position does not exonerate him from liability."

So what can be done? The answer may be that the company can persuade itself to share its confidential information with the trustees, subject to the trustees' signing a confidentiality agreement: "fiduciary duties may have to be moulded and informed by the terms of the contractual relationship" (Hilton v Barker 2005). The problem goes away.

But does this solution deal with confidential information about the company's tactics? What if directors know that the company will compromise at a given point if the trustees resist? This goes to the heart of issue that it is untenable for a person to negotiate with himself where there is a real conflict.

At a personal level, the director runs a legal risk even if he steps aside (recuses himself) from acting as a trustee in the particular situation after acquiring the information. The risk is that a court will hold that he could not whitewash the time when he was not recused and did not share the information. My own view is that the risk can be reduced if the trust deed stipulated (or there was a company – trustee agreement providing for) immunity for not sharing confidential information with co-trustees before recusal. Further, if after the director has recused himself from the trustee board, the board is able to operate adequately to go on to make a decision, the risk of criticism of the recused trustee must be further lowered.

Issue 4:
What risks is a trustee running of a member successfully challenging where the directors are in breach of trust?

To state the obvious, scheme members may be encouraged to view the outcome of an employer- trustee negotiation as compromised if any trustees have actual conflicts.

The level of risk of challenge that the FD and HR director in our case study are running by acting as trustees will depend on whether the facts make the conflict acute or not. It will also depend on exactly how the trustee board reacts to the company's proposal and the ultimate outcome. If the FD and HR director go "native in the trustee meeting setting" and negotiate an increase in funding and a moratorium on the cessation of accrual, then clearly risk of challenge must be minimal.

A word of warning: if members were to bring legal proceedings the trustees would be on risk for costs (Breadner v Granville-Grossman No.2 (2000)). Members tend, as we know, to bring Pensions Ombudsman complaints (where awards of costs are exceptionally rare) rather than court proceedings, so the risk should not be hyped. Furthermore the trustees would bear the burden of proof to show the end result was "reasonable and proper" to avoid a Court holding it invalid. The court stated in Hillsdown v PO (1996):

"The fact that negotiations have been conducted by persons, one of whom had a conflict of duties, puts upon those who say the transaction in question should be upheld the onus of proving that it was indeed reasonable and proper. That of course involves an investigation of the facts."

Issue 5:
What risks are the trustees running of tPR sanction?

The first point to clarify is that whilst tPR has produced guidance on managing conflicts, there is no automatic sanction for breach of that guidance. It is only "guidance". However, tPR does have a weapon up its sleeve:

62. Where a conflict comes to the attention of the regulator and the regulator considers that it is not being managed appropriately, we will take appropriate action. In some circumstances this might include the **replacement of a trustee(s) and/or the appointment of an independent trustee…** By way of example only, such conflicts may arise:

62.1 …..

62.2 ….. where the trustees of a scheme in deficit have to assess either over a short or extended period whether to demand a substantial contribution from an employer in financial difficulties or… triggering a similar demand under section 75 of the Pensions Act 1995."

The Regulator's powers to remove and appoint replacement trustees lie in sections 3 and 7 of Pensions Act 1995 and turn on whether it is, "necessary to secure the proper use or application of the assets of the scheme.". It is not a power the Regulator uses lightly, but it does use it.

Examples of tPR intervening where there are untenable conflicts are publically available on their website. Go visit it after Match of the Day has finished. One example is DP Dental Laboratory Retirement Benefit Scheme – The Pensions Regulator Determinations Panel (2008) stated:

"The Panel considered that there were plainly instances in which the Lay Trustees had failed to manage their conflicts of interest appropriately and had allowed themselves to participate in decisions and agreed to a course of action which, at the least, could give the appearance of them giving preference to their personal interests."

Issue 6: What steps can be taken to mitigate risk in the case study?

The key issue is what can be done to mitigate the risk of successful challenge by members or tPR.

The first is to ensure that the trust deed clearly permits potential conflicts. The second is for the trust deed or an agreement to make clear that confidential information is not disclosable either way. The third is that the FD resigns as trustee before the valuation process begins. But if he does not resign, he at least recuses himself at the outset and the trustee board operates by sub-committee without any FD involvement. This should at least satisfy tPR who states in its guidance:

"67. Trustees should consider whether the presence of a conflicted trustee could undermine discussions or...invalidate a decision. A trustee who simply abstains may still unduly influence an outcome."

Fourth, the HR director and the FD should recuse themselves on cessation proposals and the trustee board should operate by subcommittee without them.

Fifth, trustees would be advised to take legal advice on the specific facts.

Sixth, there is value in appointing an independent professional chairman with sufficient experience and force of personality to:

- police conflict management effectively
- assist with member perception; and
- help meet the burden of proof that the outcome is reasonable and proper.

Seventh, in exceptional circumstances an application to court can be made whereby the court effectively sanctions the handling of the conflict. The costs of the court application can be mitigated by having taken out the **OPDU** court application costs coverage insurance extension*. The court blessing route was recognised in the decision of Public Trustee v Cooper (1997) where Hart J said:

"Trustees may honestly and reasonably believe that, notwithstanding [an actual] conflict affecting one or more of their number, they are nevertheless able fairly and reasonably to take the decision. In this third case, it will usually be prudent, if time allows, for the trustees to allow their proposed exercise of discretion to be scrutinised by the court…"

These seven steps are ways to reduce risk. They are not my diktats. It is for you and your adviser to judge the facts and what the risks are and then react accordingly. But as standards of accountability, propriety and transparency become ineluctably ever higher, if you are going to play the conflicts game they'll need to be singing Pete Townsend's words about you:

He's a pinball wizard
There has got to be a twist.
A pinball wizard,
S'got such a supple wrist….

He's got crazy flipper fingers
Never seen him fall
That deaf, dumb and blind kid
Sure plays a mean pinball!!

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Managing investment risk DB:
The case for Fiduciary Management

Ian Bailey *Co-Head, Aon Hewitt Delegated Consulting Services*

Fiduciary management is gathering significant momentum amongst defined benefit pension schemes.

What is it about fiduciary management that is attracting so many trustees to now consider fiduciary management over the more traditional investment consulting advisory route?

Fiduciary management, where the trustees of the pension scheme delegate implementation of their investment strategy and day-to-day investment decisions, has grown over the last few years. There is no specific definition of what fiduciary management is exactly, and it is often easier to highlight what it is not. However, it can come under a number of different guises including delegated consulting and implemented consulting – all of which can mean broadly the same thing: the trustees have decided to outsource the day-to-day management and implementation of their investment strategy to a third party investment firm.

Within this article we look at the case for fiduciary management. We show why it really boils down to a choice of delivery method for trustees – which largely depends on their own internal governance framework. We start by looking at the ways in which fiduciary management is similar to the traditional investment advisory approach.

What is the starting point for pension schemes?

Over the last five years defined benefit (DB) pension schemes have seen a large amount of volatility in funding levels. Volatile equity markets, affecting asset values, and falling gilt yields (reaching historic lows) have significantly increased scheme liabilities. In effect, pension schemes have been hit by a 'double whammy' of poor economic conditions. The result – most schemes have been left severely underfunded. The average funding level in the FTSE 350 being around 60% funded on a buy-out basis and 90% funded on an accounting basis. The starting point for pension schemes does not change – regardless of whether they opt for a fiduciary management route or stay within a more traditional offering, it is the first step to towards the final destination.

What is the final destination for pension schemes?

The final destination – or end-game – for most pension schemes is to be fully funded on a buy-out basis within a reasonable time frame – many citing within the next 10 to 20 years as the target.

The current deficits can be repaired either by additional contributions or from investment returns in excess of those allowed for in the actuarial valuation - or a combination of the two. Ultimately the vast majority of pension schemes are heading in the same direction with a clear end-game in mind.

What risks do pension schemes face, moving from their starting position to their final destination?

In order to navigate the assets from the current starting point, to the final destination pension schemes will face a number of risks. Unless the scheme sponsor has very deep pockets, the majority of under-funded pension schemes will need additional investment returns to pay benefits, meaning that investment risk needs to be taken. For most schemes, the biggest areas of risk versus the liabilities arise from a mismatch between the assets and liabilities.

Pension scheme risk is generally dominated by 3 key investment risks.

- Equity risk - most schemes are heavily reliant upon equities to generate additional returns – this in itself means asset performance can be highly volatile.
- Interest rate and inflation risks – the vast majority of pension schemes, even those with hedging programmes in place, remain considerably under-hedged to both changes in interest rates and higher than expected future inflation.

There are of course other risks – for example longevity and sponsor covenant – but for many schemes success or failure is largely dependent on the investment risks highlighted above.

However, these risks are prevalent regardless of whether trustees choose a traditional advisory investment model or a fiduciary model. In fact, it is often due to the very complex nature of these risks trustees may opt for the fiduciary model.

What tools do trustees have at their disposal?

In order to navigate the pension assets safely from their current position to the final destination trustees have a number of tools, or investment options, at their disposal.

These tools are more or less available to all pension schemes. However, smaller schemes may only have access to pooled approaches which sometimes offer a slightly less tailored solution. Nonetheless, the broad offerings are available to all. Investment options can fall into 3 broad categories

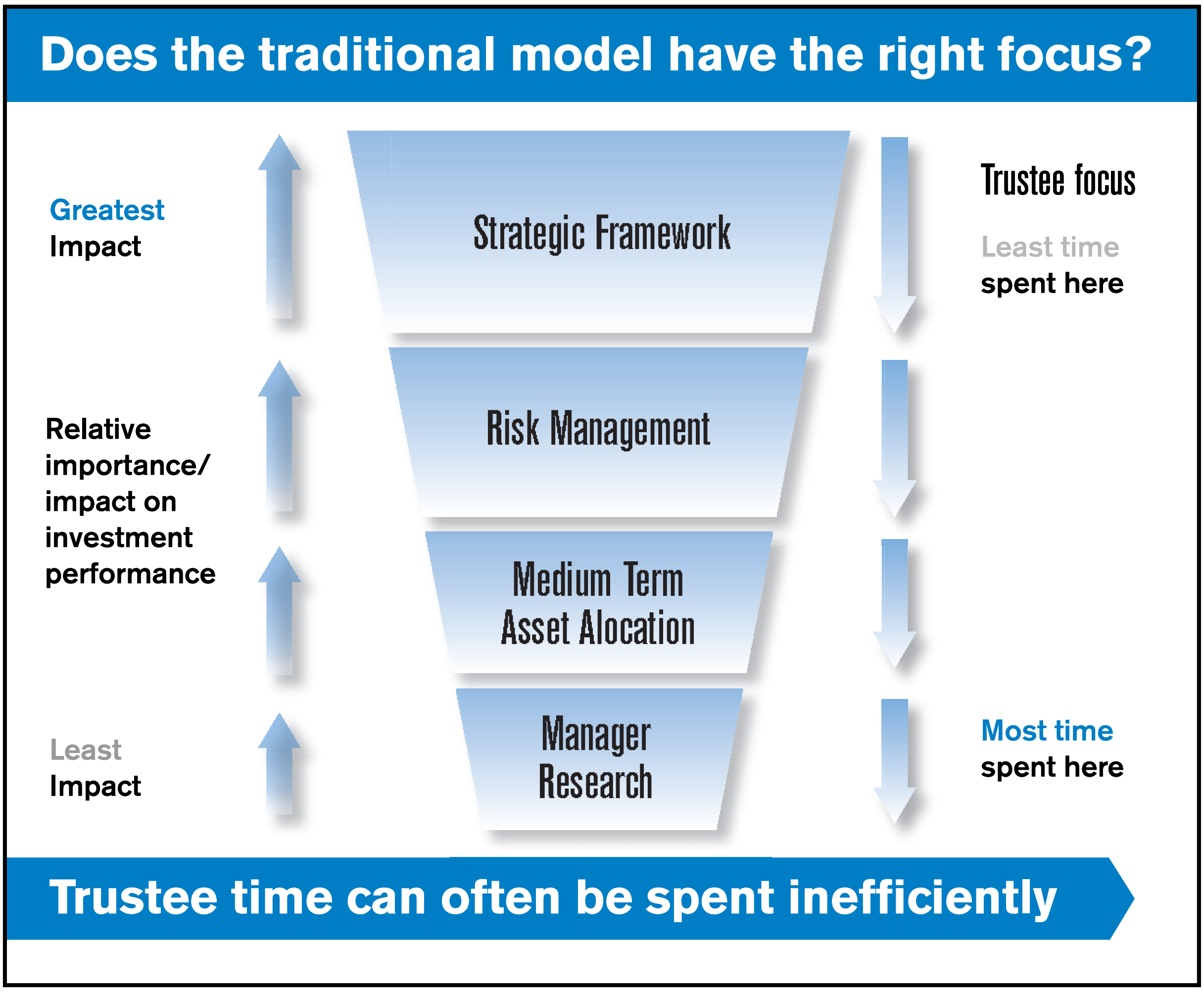
- Matching or risk controlling assets – including asset classes such as gilts, swaps, repurchase agreements and swaptions
- Growth assets – including equities, hedge funds, private equity, property and currency
- Asset allocation or dynamic de/re-risking – derivative overlays, hedging ratios and setting the timing of any transitions between growth and matching assets and between assets within these two categories.

These tools are available to trustees through the traditional investment model and the fiduciary managers.

So, why fiduciary over traditional?

With the starting point, end-game, investment risks and tools the same for trustees regardless of whether they work under a traditional investment advisory or fiduciary model, what then are the differences between the two? In short: it is about delivery.

Under a traditional advisory model, trustees take the vast majority of investment decisions, and delegate stock selection. Under a fiduciary model, the implementation of investment strategy and day-to-day decisions are delegated. Therefore the question becomes: Is a traditional advisory method of advice, or the delegation of some investment decisions, the most appropriate delivery model for managing scheme investment? Both have their place and trustees need to match up their own internal governance with the model that best fits.



The diagram above shows that a large amount of trustee time is spent on manager monitoring rather than the overall strategy and risk management. This is in direct inverse proportion to the impact on investment performance.

Fiduciary management puts governance at its core by ensuring adequate time is spent on those areas that have the biggest impact on funding levels. Improved governance means the time taken to make decisions is significantly reduced and the full investment toolkit is utilised to its best ability.

At the outset, fiduciary management may feel like a 'marked change' from the traditional investment advisory model – and, many trustees have cited a lack of control as a reason why fiduciary management may not be right for their scheme.

However, when you scratch the surface and really compare what separates fiduciary management from the more traditional advisory model you realise it's not that much.

Simply, the investment process is managed full time by professionals – according to the strategy, and within the parameters, set by the trustees. And, the small change for governance can have a positive impact on future expected risk and returns within the pension scheme.

To illustrate the difference we have set out a brief example of a global equity manager selection exercise using the traditional approach and compare this to how the approach would change under a fiduciary management model.

The firm appointed to assist with the selection exercise will broadly follow the steps below:

- Initially the entire universe of global equity managers would be considered
- A first stage screen would rule out a significant number as not suitable for a number of reasons, such as track record
- Those passing the initial screen would be subject to a more in depth analysis
- This further level of screening would produce a long list
- The long list would be subject to onsite research, more detailed analysis still and put under the operational due diligence microsope
- Only those managers passing all of the above stages would be considered for the shortlist
- The consultancy will then propose a final short list of global equity managers to present to the trustees under a beauty parade. This short list will be constructed based on the specific requirements of the pension scheme.
- The final stage is for the trustees to appoint one or more of the shortlisted fund managers.

With fiduciary management, the last two steps are the only ones that change: the shortlisted managers would not present to the trustee board at a beauty parade and the final decision as to which managers to appoint would be taken by the fiduciary manager. This vastly reduces the time taken to appoint the new managers – all trustees will know within the traditional consulting model it can easily take 12 months from shortlist to appointment – and significantly frees up trustees to focus on the bigger strategic decisions. Therefore fiduciary management can improve governance and ultimately lead to more positive expected outcomes.

There have been a number of market surveys in the last twelve months which provide insight in to trustees' perceptions of fiduciary management. These include Aon Hewitt's Delegated Survey 2011 and the KPMG 2011 UK Fiduciary Market Survey. One of these surveys asks trustees to list the top reasons why they are opting for fiduciary management. The top four were:

1. **Speed of decision making**

2. **Speed of implementation**

3. **Control by trustees**

4. **Trustee knowledge**

Perhaps the most surprising of these is that trustees feel that they have greater control using fiduciary management rather than less. This could be because the strategies that the trustees set are able to be implemented more quickly and without the burden of the smaller decisions resting with the trustees who themselves have limited time.

What are the key benefits trustees can expect if they appoint a fiduciary manager?

Trustees should expect a more diverse portfolio using the full spectrum of investment opportunities. This will help smooth future expected returns. Overall risk management would be enhanced with the portfolio being constructed as a whole and risks monitored daily. This should result in fewer nasty surprises. The portfolio will be constructed with reference to the pension schemes' unique liabilities, using hedging strategies where appropriate and thus stabilising the funding level. With decisions made by investment professionals – in real time as opposed to committee time – the ability to capture market opportunities and lock in profits is greatly enhanced. All of the above can be combined with the ability to dynamically de-risk the pension scheme over time, meaning that fiduciary management really can assist trustees in meeting their goals. Finally, fiduciary management allows pension schemes to bulk buy services and so can be very attractive from an overall fees perspective.

Conclusion

It is hoped that this article demonstrates that a small change in governance can lead to significant benefits for many pension schemes. Pension schemes often have the same starting point with a similar end-game in mind. They also have the same toolkit to manage very similar risks. The differences between the traditional advisory model and fiduciary management are governance and delivery. There is a trend towards fiduciary management with this looking set to continue. The improved governance in the fiduciary model could lead to better outcomes for your pension scheme – and, after all, this is the common goal for trustees, sponsors and members.

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Managing investment risk DB:

Why should pension schemes use an independent investment adviser (rather than fiduciary management)

Gavin Orpin *Partner and Head of Lane Clark & Peacock Trustee Investment Consulting*

I question whether, for the typical pension fund, the advantages outweigh the significant disadvantages, and believe a number of the benefits of fiduciary management can in fact be achieved through the traditional investment advisory model.

What is fiduciary management?

Fiduciary management is asset management. It involves trustees outsourcing the majority of investment decisions, including the choice of asset classes and the selection of fund managers. The fiduciary manager's benchmark will generally be related to the liabilities of the scheme, so fiduciary management also tends to involve decisions on the level of liability hedging to be undertaken.

Fiduciary management or implemented consulting?

In my view there is no difference. The two phrases have arisen because of the different providers in the market: whilst traditional asset management firms tend to refer to themselves as fiduciary managers, investment consultants tend to refer to implemented consulting.

Why use fiduciary management?

The main arguments given by providers in favour of fiduciary management are that it allows faster, more tactical decision making, outside of the traditional trustee governance process, and that greater involvement of investment professionals in decision making should lead to superior risk control and performance.

Why do I think that using an independent investment adviser is more appropriate?

I question whether, for the typical pension fund, the advantages outweigh the significant disadvantages, and believe a number of the benefits of fiduciary management can in fact be achieved through the traditional investment advisory model.

I believe that fiduciary management is not appropriate for the majority of UK pension schemes for the following reasons:

1. Conflicts of interest – There can be significant conflicts of interest. If a provider also offers traditional consultancy advice they may be

able to increase their fees by getting clients to switch to a fiduciary model. Fiduciary managers may be paid a performance fee based on short term performance, meaning that they will be focused on adding value in the short term and be less inclined to take longer term "thematic" positions.

For UK pension schemes it is generally long term performance that is the most important and therefore schemes should look to take advantage of longer term opportunities. Also performance fees can encourage risk-taking, as the manager is rewarded on the upside but does not suffer proportionately on the downside. Furthermore, there may be a disincentive for fiduciary managers to de-risk if they suffer a reduction in fees as a result.

2. Tailored advice – An adviser can tailor the advice to incorporate trustees' preferences such as ethical investment, passive management or limited liability hedging due to low gilt yields. This is likely to be less easy with fiduciary management where performance and fees may be closely aligned with a liability benchmark.

3. Not necessary for efficient portfolios – Many of the benefits of fiduciary management can be easily incorporated into a pension scheme by other cheaper, simpler ways. These may include using diversified multi-asset managers to make tactical decisions, automated de-risking triggers and efficient governance using investment sub-committees.

4. Concentration of risk – By using fiduciary management, trustees are handing over all of their investment decision making to one firm, creating a big risk of underperformance from poor strategic or tactical decisions. Many trustees are reluctant to invest even a quarter of their assets with one active manager for this reason. By using an investment adviser it is easy to diversify, and hence reduce concentration risk.

5. Higher fees – The complexity of fiduciary management arrangements, generally relying heavily on active management, mean that the fiduciary management route may be significantly more expensive than the traditional advisory model.

6. Easy to switch – in the event of dissatisfaction with performance it is very easy to switch to a new investment adviser, without selling any assets. This is almost certainly not the case for a fiduciary manager where it is likely that complex portfolios may need to be moved or liquidated.

7. Difficulty of monitoring – Due to the complex nature of many fiduciary mandates, it is often difficult to assess how successful a manager has been. Therefore, increasingly, schemes which use fiduciary managers are appointing additional specialists to monitor and advise them on this aspect, which adds to the cost.

8. Unproven – Virtually all fiduciary managers have very limited past track records and the approach may not generate the hoped for performance. An example is the experience of "manager of managers" in the early 2000s where after an initial flurry of interest, actual performance was often very disappointing. Poor performance in the fiduciary manager sector has already occurred in the Netherlands where there is more historic experience, a key example being Pensioenfonds Vervoer, a large Dutch pension scheme, which terminated Goldman Sachs for a €7bn mandate in April 2010 for poor performance, only 4 years after appointing them. It took this scheme another 18 months to appoint a replacement. In addition the Dutch Pensions Regulator is increasingly intervening and becoming concerned by the tendency to rely on just one organisation.

9. Lack of investment management experience – I question whether some consultancy-based fiduciary managers have the necessary depth of fund management expertise, meaning that they may be potentially ill-equipped to deal with the demands required.

Finally, trustees who appoint a fiduciary manager are delegating a lot of decisions, but retaining the responsibility for the performance of the investments. For fiduciary management to be successful, trustees must address a number of questions:

How do they select the right fiduciary manager?

How do they gain comfort that the investments are being managed in the long-term interests of the beneficiaries and that fees remain proportionate and competitive?

What controls do they wish to put in place?

How will they monitor investment performance?

Trustees retain the high-level strategic decision with regard to the level of investment return to target: when and how do they review this decision, and is their manager conflicted in advising them on it?

The list goes on.

In conclusion, I believe that for most pension schemes, the traditional approach of having an independent investment adviser is the best one.

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Managing investment risk DB:

How to monitor your Fiduciary Manager

John Heskett *Senior Adviser, Allenbridge Epic Investment Advisers Limited*

I start from the view that fiduciary management is a step in the right direction. Responsibility for alpha generation (using an 'open architecture 'structure') and the execution of strategy is now delegated to a fiduciary manager ('FM'). As a result, a pension fund is more flexible, better able to capture returns and achieve clearly stated funding objectives.

Writing as a trustee experienced in investment, this is a huge relief because we cannot easily continue to exercise direct responsibility in these areas. The oversight of large diversified portfolios below broad asset allocation level requires more attention than trustees can be expected to give.

However, trustees remain in ultimate charge and cannot delegate away portfolio strategy on which portfolio construction depends. None of the problems in assessing performance and effectiveness have gone away and trustees have to ensure that they have the necessary skills available to them to tackle these problems. They have to know when things have gone wrong – ie. funding levels are not improving as they should - and be able to execute an exit strategy, if necessary.

Fiduciary management has been associated with large funds on cost grounds but there are effective solutions available for smaller funds. Here, the strategic consulting part of fiduciary management remains in place – albeit more simply constructed .The investment part of the package would consist of the purchase of diversified growth funds – more energised, growth orientated, diversified versions of the old 'balanced 'portfolios, where there are very respectable track records available - to run alongside the liability matching part of the portfolio.

There are a number of ways of making monitoring easier. One way is to ensure you hire the best provider. This is a very important appointment that deserves a competition and, while this is time consuming, the exercise will be beneficial because trustees will learn about this relatively new fiduciary management offering and establish links with a number of participants and their processes. This has to be valuable for the future. There is, otherwise, a danger that trustees will remain more isolated than they should, feeding off what their existing consultant tells them, as he morphs from consultant to the fund 's new FM. With all the conflicts that might be contained in such a move. Such conflicts fall away, of course, if there is competition.

Morphing, however, is prevalent – if not the norm. This is, in some ways, not surprising because trustees, consultant and sponsor know each other well and have confidence in each other; there is broad agreement already in place on investment philosophy, strategic framework and flightpath. There is a shared approach to de-risking and possibly now re-risking – a relevant question to ask in these days of sub-zero real yields. Agreement on philosophy and approach is hugely important and an essential in any relationship. However, fiduciary management requires significant resources at a number of different levels – strategic, portfolio construction, manager selection, execution. Not all the 15+ providers in the UK are going to have them. Hence the need to look around.

This broad agreement with your FM extends to where the risks should fall. In the growth segment of the portfolio, there are four main categories – equity risk premium, credit, illiquidity and skill. Depending on how risk is distributed will depend asset selection – and diversity of asset allocation – and consequent portfolio construction. Volatility and liquidity constraints will also impact here. Trustees have to ensure that the extra cost – of fiduciary management, manager diversification, asset diversification – is worthwhile relative to identified added value or reduced volatility. Everyone is trying to design the optimum, diversified growth, low volatility portfolio, but these can be expensive in total expense ratio terms. Trustees have to arrive at the trade-offs and then monitor.

This top level portfolio construction work accounts for c. 80% of a growth portfolio return, according to one very respected FM participant (with c. 15% arising from successful access to skill and c. 5% arising from tactical shifts). Accordingly, it is an area of high risk, where trustees need to focus attention and have an idea of how similar funds are positioned.

Notwithstanding its relatively low contribution to returns, successful access to alpha will continue to be important in the new FM and trustee relationship but not as important as it has been hitherto. The more alpha is needed and not attained, the more the relationship will come under pressure, but alpha needs to be seen in perspective. How much does the fund need? How much can it expect and at what cost? In what areas is the budget for alpha generation to be spent? If a process can be agreed on, that will form a solid foundation for the fund and will avoid problems later on.

In the return seeking segment, there needs to be a clear idea of how to access consistent alpha in the equity space – blending portfolios to cover different opportunity sets/styles and to avoid manager concentration (what a change from the past, where four or five fund manager providers had a lock on the UK pension fund market!). We need to test the equity segment for bad times – and decide whether potentially higher beta strategies (eg. quant, deep value) are wanted. We need to be clear on how we are accessing the emerging market growth opportunity and where we should be using more passive/enhanced indexing (to control underlying portfolio volatility, if nothing else). We need to have a common approach for private equity – an area of falling and wildly disparate returns and high costs.

In the volatility mitigation segment, there needs to be a shared view on the merits/demerits of hedge funds and what they are 'for', given high costs and worryingly disappointing returns, resulting from too much beta and not enough alpha. The FM has to have a proven record in this difficult area if hedge funds are to be used because they are going to take up more than their fair share of the skills budget. The alternative is to avoid and concentrate instead on the more transparent, ungeared, much cheaper real return orientated universe – where there are now track records from a very respectable universe of managers. This looks to be a more intelligent use of equity/beta exposure .

These conversations will extend to the use of a number of other alternative asset classes in what might be described as the inflation matching segment – property, commodities and infrastructure. On all of these, the FM - and the trustees - will be expected to have well supported views, with the FM having the ability to identify consistent, reliable, best-in-class providers. In all, there is a lot to research and it has to be done well to achieve consistency of alpha, which is otherwise unreliable and inconsistent. 'Simplify or raise your game' said a leading consultant, some 12 months ago. The main by-product of raising one's game is a much larger universe of managers used in much smaller segments.

I mentioned earlier the possible performance impact of tactical shifts. We want the fund to be flexible and it will be interesting to see what processes FMs will use to respond to the ability to make these shifts, within clearly defined limits and with clearly defined return/volatility objectives in mind. Time will tell whether tactical shifts will amount to something more than rebalancing.

When it comes to strategic consultancy and portfolio positioning, it is important that the FM has well founded beliefs, which can inform the process. Ensure you buy the firm, not the manager. The FM's account manager should not be a taxi driver, buying into sponsor and trustee preferences on the basis that his client's fund is somehow unique. Trustees want to buy the firm and what the firm thinks should be the 'normal' portfolio, given the circumstances, following a 'normal' process to improve funding levels. So identify where the variances from normal may be and ensure that, within the FM, there are internal review processes to ensure their fund is positioned in line with others.

A key element in monitoring an FM is whether he can account satisfactorily for costs – not only his own but dealing and execution costs and costs paid for fund managers. He has to give the trustees confidence not only that the fund is spending wisely but that the TER on the fund is in line with equivalent funds. As to the FM's own costs, that will partially depend on what is sought in the portfolio construction exercise and the level of immunisation. Performance fees would be inappropriate – given that funding level improvements/ deteriorations result from factors outside an FM's control - but part of the fee should relate to the size of and growth in growth assets. Risk management and the liability matching side of his work also need to be fully recognised.

Good governance points to the fund having a solid counterweight to your fiduciary manager – within the trustee board/the sponsor. This would be optimal for a smaller fund, where there may not be an investment committee; interestingly, there are a rising number of professional trustees coming forward to meet this need. These skills could also be made available to the board/sponsor through a third party investment adviser, such as Allenbridge Epic. Hymans is the most visible appointment, acting for MNOPF, with Towers Watson acting as FM. The Dutch firm Avida is worth mentioning in this context to provide some foreign colour from the country where fiduciary management started.

Trustees will have regular audits on their own effectiveness; usually surveys in this area point to the need for more investment experience and any switch to a fiduciary management arrangement does not lessen the need for that – it increases it. My only suggestion here is that trustees spend time accessing other FM providers, to compare and contrast service levels and, more importantly, performance. If we want to monitor our FMs effectively, we need to monitor and understand the new environment. We also need to spend time on monitoring ourselves and our effectiveness. The FM is a key relationship. The more he can be constructively questioned and challenged as the relationship takes its course, the more likely we are to ensure a successful outcome.

Summing up, here is how I would approach compiling my final scorecard for my FM:

- Monitoring strategic flightpath (liabilities and assets) – increased focus on changes in liabilities and liability management. Trustees have to be confident of FM input at this top level
- Risk monitoring and management – assessing risk in the light of where we are on the flightpath and reducing/adding accordingly
- Market awareness – assessing how market conditions are changing and how this should impact on central asset allocation, the risk/return profile and the search for alpha
- Successful access to alpha – the FM does access 'best in class'. More targeted approach working to a budget should lead to cost savings in this area, which should offset higher costs elsewhere
- Tactical asset allocation – a positive contribution to either returns or volatility reduction
- Accountability – for performance, good execution of asset and hedging strategies, good linkage with actuaries, custodians and administrators
- Cost control – the FM works within his budgets. The trade-off between higher FM costs and a better performance/volatility outcome works. The TER of the fund is competitive
- Sponsor response – if the sponsor, who underwrites the whole endeavour, is happy this will reinforce trustee confidence that the fund is on the right track.

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DC – Is it time for a re-think?:

Understanding the human element of investing for the future

Chris Hitchen *Trustee Member, NEST Corporation*

For those of us in the pensions industry it's easy to make assumptions about the knowledge of typical defined contribution scheme members, but behavioural research has demonstrated that some of these assumptions are open to question.

Behavioural biases impact most people, from the financially inexperienced to the world's leading economists. Nobel Prize-winning economist Harry Markowitz once explained how he picked his pension fund's portfolio: 'I should have computed the historical covariance and drawn an efficient frontier, instead I visualised my grief if the stock market went way up if I wasn't in it – or if it went way down and I was completely in it. My intention was to minimise my future regret, so split my [retirement pot] 50/50 between bonds and equities.'

Markowitz exhibits a couple of things to note: naive diversification – asset allocation based on rules of thumb that lead to less than optimal results; and also regret bias – taking a decision so as to avoid future regret. When it comes to helping people make decisions about retirement, understanding the human element is becoming increasingly important.

Inertia is a behavioural factor that the government is hoping to harness when it introduces automatic enrolment into a pension scheme from October of this year. As you will know, instead of having to choose to join a pension scheme, the change in the law means many workers will be enrolled into schemes by their employers.

The government estimates that there will be 5-8 million people saving for the first time or saving more in all forms of workplace pension schemes following the introduction of new employer duties.

As a new, low cost and easy-to-use scheme that any employer can use to meet their new duties, and as a trust-based scheme that acts in the best interests of members, NEST is keen to innovate where we have the potential to help our members get better retirement outcomes by supporting them in making better decisions about their savings.

Automatic enrolment takes the first step to tackling the problem that millions of people in the UK are not saving for their retirement, but it follows that one of the biggest questions for NEST, and for the other schemes employers can choose to automatically enrol their workers into, is about keeping people saving. Automatic enrolment will mean a large influx of new pension savers with different features to traditional investors, those whom we may feel more comfortable making assumptions about.

The target group for automatic enrolment is strikingly different to the population currently saving into a pension. While median earnings in the target group are around £20,000, median earnings of those contributing to a pension are around £30,000.

This means NEST's members are likely to have less familiarity with financial products than existing savers. Those with pensions currently are more likely to have higher levels of savings and to work in managerial or professional jobs.

Our research also shows that on balance our target group is more risk averse than risk seeking with a large proportion (37 per cent) of the target group favouring taking no risk whatsoever with retirement savings. Risk preferences also trend by income with those on lower incomes being more likely to be risk averse than those on higher incomes. Our research also showed that younger people have some of the strongest reactions to investment loss.

The research also showed that the target group is likely to have negative and emotional responses to investment loss. The research observed: disappointment, anger, surprise and incredulity when research participants were confronted with hypothetical investment losses. Loss was also felt with a sense of immediacy and was not considered within the context of a long-term savings vehicle. Loss aversion was observed most strongly among the young, who were often the most risk seeking, and those on low incomes.

When we look at designing a default approach for our members, there are three areas of risk in tension with each other – the risks that people want to take (their risk appetite), the risks people can take (their risk capacity) and the risks people need to take to deliver a retirement income. The challenge for developing the investment approach has been to balance these three factors.

We need to manage our members' exposure to risk to encourage them to save regularly and build up retirement savings over their working life as keeping people saving once enrolled is, of course, absolutely vital to peoples' retirement incomes.

We've designed our investment approach for the earliest years of younger members saving with NEST in a way that seeks to get them saving and keep them saving. Our objective in this, the 'Foundation' phase, is to keep pace with inflation after all charges, while reducing the likelihood of loss.

Our analysis suggests the amount of return that could theoretically be given up by experiencing the Foundation phase is less than 2 per cent over a 45-year savings period, compared to the same portfolio without a Foundation phase. To put it another way, you lose less than 2 per cent over a lifetime saving by having a Foundation phase, but if you get spooked out of saving by seeing big losses when you first start out, you risk destroying completely that younger member's chances of building up a pot over their lifetime. NEST's members won't stay in the Foundation phase for long - as they get used to saving, they'll be transitioned into more return-seeking assets throughout the 'Growth' phase, which lasts for decades until the member gets closer to retirement.

In the Growth phase we target 3 per cent growth above inflation after all charges by investing in a higher proportion of return-seeking assets, within our given risk limits. Members' pots are invested in a well-diversified portfolio, where risk is monitored and managed dynamically by our in-house investment professionals. Members could spend up to 30 years in this phase.

The 'Consolidation' phase starts around 10 years before retirement. We gradually move members' pots into assets that broadly reflect the way we expect them to take their money out of NEST. We expect to grow each pot by more than the cost of living during this phase, but our primary focus is securing the member's retirement income and protecting their pot from sharp falls in equities and other growth assets.

We conduct extensive modelling and stress testing of our approach to ensure that it's likely to achieve what we set out to do. Our analysis shows that nearly 80 per cent of modelled scenarios using just a static strategic asset allocation deliver investment growth of more than 3 per cent after allowing for inflation and charges and in more than 95 per cent of the investment scenarios we achieve our investment objective of outperforming inflation.

This analysis also shows that it's very unlikely that a member's final retirement pot will be less than their contributions. This is very different from other strategies available to UK savers, which tend to focus on single asset classes or don't take account of whether the investment is suitable to the economic environment or market regime. These result in a wide spread of outcomes depending on when people save and when they retire, creating a pensions birth-date lottery. Our holistic approach to managing risk throughout a lifetime of saving delivers a more balanced return for all members.

We don't have all the answers on how to encourage those members who've been automatically enrolled into a scheme to develop and maintain the saving habit. However, NEST is committed to continuing to develop ways to help our members achieve good outcomes when it comes to their retirement income.

Chris Hitchen
NEST Corporation Trustee Member and Chair of NEST's Investment Committee

DC – Is it time for a re-think?:

Pensions – managing risk in DC

Morten Nilsson *Chief Executive NOW:Pensions*

The move from DB to DC has changed the landscape of the pensions industry, risk has now shifted from pension funds and/or employers to the individuals who bear all the investment and interest rate risk.

In exchange members have been provided with the opportunity to make their own investment decisions and thereby theoretically the chance to create higher returns through informed investment decisions.

The result has however been lack of engagement around pensions and poor performance for most of the members.

Simplicity is at the heart of promoting confidence in the UK's pensions system, the industry has been characterised by complexity for too long. All over the developed world efforts have been taken to improve engagement through offering better and more intuitive web solutions with added tools to profile risk and choose funds. However much of this effort has not had the desired effect and many people have lost confidence in the system.

The lack of understanding around pensions, the overwhelming choices available and the relative poor performance of default funds have meant that people have become distrustful of pensions and the system. Members have expressed lack of interest in investment in many ways, and still the basic DC offering is providing them with an overwhelming amount of choice.

Let me give you an example, in the mid 00's ATP offered a DC plan for 3.5 million members. This plan included the very best tools allowing members to invest their savings as well as the option to invest with ATP or let ATP handle everything for you.

The DC plan showed that 10,000 out of the 3.5 million people made active investment decisions and when looking into the demographics they were predominantly males in their mid-thirties. This cohort of members were shown to be taking excessive risk and often were not in sync with markets and were buying when they should be selling and vice versa.

All our research in both the UK and other countries has delivered similar results. Consumers are generally not very investment savvy, they are not very interested and often make poor investment decisions.

Our conclusion is therefore simple, members do not want to invest their savings, they are not interested enough and the majority do not have the investment knowledge to do so. So as a pension scheme provider we make the investment decisions for our members. Our experience has shown that by relieving our members of the burden of investment choice they get more engaged in their pension savings and get better outcomes.

NOW:Pensions has joined the UK market because we believe it is about time everybody got a better pension and we deliver a product, where our core focus is our members. NOW:Pensions is a new, independent multi-employer trust which is supported by ATP, Denmark's leading pension's provider.

Using the learning's from Denmark, NOW:Pensions offers a simple pension product and really work with defaults to optimise customer experience, reduce costs and deliver better value. Making it easy for employers will be very important for auto enrolment to succeed. NOW:Pensions is offering a straight forward auto enrolment solution to test and enrol those employees who are required to join a scheme to ensure participating companies comply with the new legislation.

ATP has helped all Danish companies and their employees since being founded in 1964. Along the way, it has won numerous pension industry awards, including Investment & Pensions Europe (IPE)'s gold awards for Best European Pension Fund (2011; 2009; and 2005) and Best Long Term Investment Strategy (2011). ATP is keen to share its long-standing experience of delivering low-cost pensions with its proven investment track record – the firm has been providing Denmark's working population (4.7 million members) with stable, consistent returns over the past 45 years. ATP achieved a compounded return on investment of +10.3 per cent p.a. for the past ten years, which is significantly higher than the UK average year on year.

ATP's consistent investment performance is based on a very strong risk management set-up. It has diversified its investments aggressively, including achieving excellent returns by spreading risk across five risk classes- rates, credit, equity, inflation and commodities and it has had a strong hedging strategy, getting rid of risks that are not rewarded or where the down side risk is not acceptable. This, combined with world class in-house investment management capabilities gives a low cost and highly agile portfolio.

NOW:Pensions is combining this expertise with an uncomplicated, efficient administrative structure delivered via our business partner Xafinity Paymaster to maximise returns for our members.

Pension providers need to be trusted

The first step to promoting good outcomes for pension scheme members, is building trust and confidence in the industry. The current problem in the UK is the lack of transparency within the market and high charges that impact upon a member's pension pot.

Building the trust of members requires a governance structure that examines and scrutinises the entire scheme, including the investment strategy and performance, making sure members' interests are being served. An independent board of Trustees who have a legal duty to take care of members and oversee the pension scheme is at the heart of building confidence in members and providing them with the reassurance that their money is being invested carefully. The fund should be governed by the Trustees who will monitor the performance of the management team and the investment manager. There should be very detailed and clear governance structures securing both an efficient and quality handling of the trust's assets and ensuring that member interests are served at all times.

The NOW:Pensions Board of Trustees includes; Nigel Waterson former Shadow Pensions minister, Chris Daykin former government actuary, Imelda Walsh former group HR director of Sainsbury's, Lord Monks former secretary general of the ETUC and the TUC, Lars Rohde Group CEO of ATP and Win Robbins Former Head of European Fixed Income at Barclays Global Investors. NOW:Pensions has appointed a Board of Trustees to safeguard members' interests, protect records and rigorously assess the fund's performance.

The advent of automatic enrolment has created a need for a simple pension solution as employers are burdened with the responsibility of choosing a pension scheme. As the discrepancies between the most expensive and cheapest pension plans are huge this can have an overwhelming effect on members' savings. Those schemes that offer a transparent and cost effective solution, with a viable business model and offer a strong investment default, we believe will succeed in the market. There is a need for a simplification of the system and lower charges to help promote savings. NOW:Pensions is offering a cost effective transparent solution that has no hidden charges and does not pay commission to advisors.

Diversified growth funds

Savers are looking for future security and that is why DC schemes should think and behave more like DB schemes. Their approach and thinking should be concentrated on the overall liabilities and how they can best support the members through to retirement and ensure they get the best possible value for their savings. This is about handling the investment risks and protecting members against interest rate risk.

Integral to the success of NOW:Pensions' investment managers ATP, has been the use of a managed diversified growth fund that has provided consistent returns for members. In the UK the typical default funds have asset allocations that are highly weighted towards equities; however for the past decade equities haven't performed sufficiently well to allow such a high allocation and with all the uncertainty on the economic outlook we believe that the most appropriate method of investing is to get investment risk through a much broader mix of risk classes.

The heavy losses funds have suffered has resulted in a shift in thinking towards diversified investment models, however this model is not new and has been used by ATP for many years. While many funds may now be moving towards the investment strategy of employing a more diversified model, it can be an expensive strategy to adopt if scale is not gained. NOW:Pensions charge of just 0.3% for a managed diversified growth fund is exceptional and proves that scale can deliver long term benefits for members.

NOW:Pensions' investment approach is based on the fact that 80-95% of all pension returns are achieved from exposure to market risk and appropriate exposure will yield long-terms returns. The NOW:Pensions investment philosophy is about diversifying our assets to gain sufficient exposure to the market and focus on protecting our members against what might go wrong. Our approach however is not just about diversifying our assets, it is about risk managing the diversification by using an approach based on risk budgeting.

There is a serious problem at the moment on how to deliver benefits to members in the low interest rate environment and the current uncertainty means our approach is to be cautious. On a member level NOW:Pensions believe hedging against changes in interest rates, enables members to level out the risk on their retirement date by combining life styling with a retirement protection fund. The current state of the financial system means that no-one is able to predict where the interest rates are headed and NOW's investment belief is that you should not try to predict the future, it is easier and more vital to look at the risk reward balance. The NOW investment philosophy centres on achieving the optimum market exposure and minimising uncompensated risk. This investment approach has proved to work and has provided our members with better value and a more secure retirement income.

Morten Nilsson
Chief Executive NOW:Pensions
www.nowpensions.com

How to avoid the Pensions Ombudsman

Tony King *Pensions Ombudsman*

I was asked by OPDU to give a talk earlier this year with the title ***"How to avoid the Pensions Ombudsman".*** I tried not to take the suggestion personally. After all, why should anyone want to avoid me? Do people flatten themselves against walls as I walk by? Why have I not noticed?

Rather than taking offence, in giving my talk, while accepting that having a complaint against a pension scheme that goes to the Pensions Ombudsman is, in principle, undesirable, I suggested that in practice, if it does happen, we are not all that unpleasant to deal with. That mission led me first to offer some background to the office, for those fortunate souls who had so far completely succeeded in avoiding us.

Who is the Pensions Ombudsman?

I am! – but as the fourth occupant of the post. The office has been open for business since 1991. We were the first ombudsman service to be established by statute dealing with private matters (following the Parliamentary Ombudsman and the Local Government Ombudsmen, dealing with public sector matters). We were by no means the first private sector ombudsman, though – that honour went to the Insurance Ombudsman, originally a voluntary ombudsman scheme having no statutory backing, now subsumed into the Financial Ombudsman Service.

And although I am the Pensions Ombudsman, I am not the only one. Since 2005 there has been power to appoint a "deputy" Pensions Ombudsman, with identical powers. The present (part time) Deputy Pensions Ombudsman is Jane Irvine.

What do we do?

To simplify considerably, we deal with complaints and disputes about personal and occupational pension schemes (which includes statutory schemes for public sector employees). Our powers are investigative and inquisitorial. Determinations and directions made by one or other of the ombudsmen are final and binding on all the parties – including the person making the complaint. That is extremely unusual for an ombudsman. Consistently (and just as unusually) our determinations are subject to appeal on a point of law to the High Court (England and Wales), Court of Session (Scotland) and Court of Appeal (Northern Ireland).

How much do we do?

We receive between 3,000 and 4,000 "enquiries" a year. Not all of them are complaints, though.

So we get letters from people who are genuinely annoyed, but not at the pension scheme. For example someone wrote recently and said "My pension has been cut by that fat idiot Gordon Brown", to which, in the interests of neutrality he added "David Cameron is Tony Blair in disguise" and then for further balance "– and a Nazi." Or we get letters from people who misunderstand our role: for example schemes occasionally try to "lodge" documents with us. And not infrequently people think we are the pensioners' ombudsman and so might write to us about their cold weather supplements (or lack of them). However, even when we cannot help people, we do our best to tell them who can. So in the last example above we would have referred the person to the DWP's Pension Service.

Where enquiries do relate to matters potentially within jurisdiction, they do not necessarily go on to be considered by us. Over 40% of enquiries either have not been through the relevant internal complaints procedure (we always expect that a complaint has been taken up with the "accused" party before we'll look at it) – or could benefit from the involvement of the Pensions Advisory Service. In the end, something under 1,000 enquiries a year become cases that are suitable for investigation.

What do people complain about?

All sorts of things. But the two biggest single categories are complaints about ill-health pensions and transfers.

In the case of ill-health pensions the reason is fairly obvious. It may be a matter of huge financial and emotional importance to the pension scheme member – and cost to the scheme. There may be difficult issues of judgment and discretion involved. Such cases are anything but black and white.

Transfers are a source of complaint for a number of reasons – but the most common is probably delay, typically resulting in being out of the market, or in missing an annuity guarantee deadline.

But it would be of no help to suggest that to avoid us you should avoid retirements and transfers. You might as well avoid pensions! No – in the words of the song "It ain't what you do, it's the way that you do it."

Good administration

We have jurisdiction over complaints of "maladministration", a term with no statutory definition. But it follows that for those seeking to avoid us, the answer must be to concentrate on good administration. When it comes to managing a business well and provide good service there is no shortage of sources of expertise, training and advice. More specifically, in the world of pensions there is regulatory guidance, industry guidance, support from professional and trade bodies – and more.

As examples of guidance from the world of ombudsmen, these are the Parliamentary Ombudsman's six principles of good administration – equally applicable in the private sector as the public sector:

- Getting it right
- Being customer focused
- Being open and accountable
- Acting fairly and proportionately
- Putting things right
- Seeking continuous improvement

Each is further developed on the Parliamentary Ombudsman's website. It is all very straightforward and uncontroversial stuff – but perhaps one option (out of many) as a starting point for anyone wanting to develop their own high level principles and think about how they may apply to day to day business.

The value of good communication

Somewhere behind a good number of the complaints we see will be a communication issue.

For example, there may be a conflict between the explanatory literature and the rules. In most cases the rules will prevail – but perhaps at the expense of unhappy scheme members and the financial cost of handling complaints. Or an estimate or quotation may be unclear (or even plain wrong). Where the scheme member has reasonably taken a step on the basis of wrong information, for the provider of the information that can be expensive indeed.

Communicating to manage expectations is important too. The complaints about ill-health retirement that I have already referred to often have, as an undercurrent, a complete mismatch between an employee's expectation of what will happen if they lose their job due to incapacity and what the pension scheme provides.

The key must be to put clarity first. That is not always easy – pensions are not simple! But sometimes schemes and providers may put themselves unnecessarily at risk. Take, for example, a recent complaint concerning two sub-funds in an open ended investment company (OEIC). The sub funds and the OEIC all had connected names, each only slightly different. The similarity was, in part at least, the cause of an investment in a wrong sub fund, followed by prolonged confusion about what had gone wrong and how to correct it. Clearer naming (and, in that case, better training) might have prevented the problem arising.

Dealing with complaints

Since I took up the post of Pensions Ombudsman in 2007 I have spent a great deal of my time pushing for proportionate approaches to complaints. It is easy to have a single process and use it for every case. It is unlikely to be as effective – whether in satisfying an unhappy customer or in cost terms – as thinking about what method of dealing with the matter best suits the circumstances. So there are some cases where a swift apology is all that is needed; there are others where the matter will never be resolved until the dissatisfied scheme member has their "day in court"; there those in which the parties are so far apart that an independent adjudication is the only practical option – and so on.

A difficult decision is when to use the formal process. We see cases in which a simple enquiry about whether something has gone goes straight to the complaint team and escalates from there. We also see cases where questions are answered repeatedly without anyone realising that something may have gone wrong.

Here are a few points to think about:

- informality may be the best starting point (but not for too long)
- don't hang about – delay adds insult to injury and is gives time for the parties to become entrenched
- keep an open mind – it is easy to be defensive
- be ready to apologise - that may go a long way to resolving the matter
- play it straight – even if you think the other party is deluded, or devious, or just plain wrong.

Putting it right

If you find that something has gone wrong, the rule of thumb is, of course, that the person should be put, as near as possible, in the position that they would have been in had everything gone smoothly. It is often much harder to achieve that than it may appear, though. There may well be judgments to be made over what would have happened without the error – and eliminating hindsight is a real difficulty. People understandably find it very difficult to say what they would have done, perhaps several years ago, in circumstances that did not actually arise.

In addition to reinstating matters as they would have been, there may be a case for modest compensation for distress, inconvenience, disappointment and so on. The long standing yardstick has been that awards by the Pensions Ombudsman should only exceptionally exceed £1,000. But that was said in a Court judgment in 1998 – so some adjustment for inflation (whether by RPI, CPI or any other measure) is perhaps due.

Dealing with us

As I suggested at the top of this article, it is our intention that when it is necessary to deal with us, doing so should not be an unpleasant experience for the parties (or indeed, for us!). I have two suggested rules.

Rule number one is (as helpfully set down by both Corporal Jones and Douglas Adams) is "Don't Panic!" I referred above to the need for proportionality. We may be able to sort the matter out informally. Increasingly, instead of immediately asking for a full response accompanied by chapter and verse (for which lawyers may be employed), we will make informal enquiries – for example about the terms of rules in a particular circumstance, or about why a certain procedure was adopted. They may make the formal approach unnecessary.

Rule number two is to remember that we are not the enemy. We will ask the parties to comply with certain timescales; if you need more time, ask. Also, we may test the stance of either side – sometimes robustly; but we really are impartial. And when we put forward one party's arguments to the other side, that does not mean we accept its validity.

Finally

There will always be mistakes; swift acknowledgment and correction is the best cure where possible. Despite what I said at the beginning of this article, there are all sorts of very good reasons to try to avoid the Pensions Ombudsman. In the end, though, there will always be matters on which two sides (or more) cannot agree. While we do not expect pension schemes and their staff and advisers to clap their hands with glee if a complaint is made to us, we would hope that we can work amicably and professionally with the parties to resolve it proportionately and without avoidable pain or expense.

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Things you may not know about Trustee Liability

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Trustee liability: good news and bad news

Trustee liability is an extremely important issue for the trustees of occupational pension schemes and, unfortunately, is also an especially complicated area of law. The aim of this article is to highlight some important things that you may not know about trustee liability – both good and bad.

To make sense of some of the twists and turns in the law on trustee liability, it is necessary to understand the underlying legal framework. We will begin by providing a brief overview of the duties and obligations of pension scheme trustees and the protections from liability generally afforded to them.

Then, we will move on to cover some important things that trustees may not be aware of, starting with what could be termed "bad news" items:

- six more unusual potential liabilities; and
- six limitations on indemnity/exoneration protection.

We will, however, also aim to redress the balance by highlighting eight "good news" items that trustees may not know of, in particular areas where:

- trustees have more protection than you might expect; or
- trustee protection can be improved.

Reminder: the duties and obligations of pension trustees

It is fair to say that being a pension scheme trustee is a pretty tricky job, and is a role that is becoming increasingly onerous as time goes on.

There is no general codification of the law relating to pension scheme trustees; no single rule book that a trustee can turn to in order to learn about his or her obligations. Instead, the rights and obligations of pension trustees are derived from a whole range of sources:

- the trust deed and rules of the pension scheme and other scheme documents
- the general law relating to trusts, both legislation and case-law
- the rafts of specific pensions legislation, both in statue and regulations; and
- other general law (e.g. contract law, data protection law, derivatives law).

Just taking one element of these obligations illustrates how onerous they are. At the heart of the general law of trusts are the core duties of skill and care, including:

- the duty to act with prudence, taking such care as an ordinary man of business would take in managing his own affairs if he were under a moral obligation to provide for others
- the duty to act in accordance with scheme documentation, no matter how complex or obscure; and
- the duty to act for a proper purpose, in the best interests of the scheme beneficiaries.

But the key cause for concern for trustees is not the (potentially overwhelming) extent of these duties, but the consequences of breaching them. This is because the general principle is that a trustee will have personal liability for loss caused by breach of duties.

Reminder: protection available for pension trustees

Of course, if pension scheme trustees were required to risk personal liability without any form of protection, you would never get anyone in their right mind to be a pension scheme trustee. Fortunately, however, trustees can and do benefit from considerable protection that enables them to avoid personal liability when things go wrong.

There is a wide range of protection commonly available, including:

- exoneration clauses in scheme rules, which provide that trustees are exempted from personal liability for breach of duty
- indemnities in the scheme rules which allow the trustees to be reimbursed from scheme assets for any liability for breach of duty
- indemnities from scheme employers, under which the trustees are reimbursed by the employers for liability for breach of duty (for example, if scheme assets are insufficient); and
- trustee insurance, which provides protection which is not dependent on the sufficiency of scheme assets or on the employer's ability to pay. This may be obtained both to provide an additional layer of protection in an on-going scheme or provide run-off protection following the winding-up of a pension scheme.

If all those avenues fail, there is also a court discretion to excuse trustees from personal liability in section 61 of the Trustee Act 1925 which allows the court to excuse a trustee where he or she has acted honestly and reasonably and ought fairly to be excused.

"Bad news" items: more unusual potential liabilities

The summary above might lead a trustee to feel quite comfortable with their position. However, numerous twists and turns in the law relating to trustee liability make a trustee feel rather uneasy again.

The perils of joint and several liability

It is often forgotten that where trustees breach their duties of care and skill, they will be "jointly and severally" liable for the loss caused to the pension scheme. Joint and several liability means that all trustees will be potentially liable for the whole of the loss suffered, regardless of whether the trustee participated in, or even knew about, the breach.

This joint and several liability continues to apply to former trustees, who remain liable for breaches during their time as trustee and can extend to new trustees who fail to remedy a breach. It also applies to all trustees regardless of their particular status (e.g. whether they are member-nominated trustees or professional trust corporations).

Because each trustee could be liable for the whole of the loss suffered, the share of the liability ultimately met by a particular trustee will depend on a number of factors, such as:

- whether the other trustees have the benefit of exoneration clauses (e.g. if exoneration clause distinguishes between protection given to lay/professional trustees); and
- the financial resources of other trustees (with "rich" trustees inevitably risking taking a greater share).

Note that the share of the liability may bear no resemblance whatsoever to the degree of culpability of the particular trustee for the wrong-doing in question. This is illustrated rather dramatically by a recent Australian case: Shail Superannuation Fund (2011).

In Shail, a husband and wife were both the trustees and the only two members of their joint pension scheme. The husband then absconded with most of the pension scheme assets (essentially stealing his wife's pension fund). However, the removal of the assets from the scheme also resulted in a significant tax charge being levied (in excess of AUS$2m).

Despite being entirely innocent of wrongdoing, the wife (as pension scheme trustee) was also liable for the tax due to the tax authorities under the joint and several liability principle – and, of course, was left to foot whole of the bill because her husband (the trustee at fault) had vanished without trace.

Liability for civil penalties

Whilst it might, perhaps, seem unfair and onerous, the principles of joint and several liability are at least aimed at addressing losses to scheme beneficiaries or liabilities of the scheme to third parties. There are, however, a wide range of statutory obligations in pensions legislation where the Pensions Regulator can issue a civil penalty (essentially akin to a fine) against trustees for a breach of that obligation, even though no loss has been caused.

A small sample of the statutory obligations in pensions legislation where the Pensions Regulator can issue a civil penalty for breach indicates the breadth of this power and the range of sometimes major but also sometimes seemingly quite trivial areas covered:

- failure to report notifiable events and breaches of the law;
- failure to provide required information to the Regulator (e.g. scheme returns);
- breach of investment and funding

legislation (e.g. failure to obtain advice);

- relying on improperly appointed advisers (e.g. where section 47 of the Pensions Act 1995 has not been complied with).

Doing a quick tally, we found more than 70 different statutory provisions (covering all areas, many of which are quite technical) where breach can result in a civil penalty.

Civil penalties can be awarded against individual trustees, trustee companies and against trustee directors (who will then be personally liable). The maximum liability (for each civil penalty) is £5,000 for an individual and £50,000 for a company.

Trustees in the "net" for the Pensions Regulator's moral hazard powers

Not only does the Pensions Regulator have the power to issue civil penalties, it can also make certain third parties liable for the deficits in defined benefit pension schemes using "contribution notices" (which require payment of a particular sum to the pension scheme) and "financial support directions" (which require financial support, such as payments or guarantees, to be put into place). These powers are commonly known as the Regulator's "moral hazard" powers.

The Regulator can use its moral hazard powers against any company (and, in the case of contribution notices, any individual) which is "connected or associated" with the employer of the pension scheme. It is important to remember that this will include many trustees (both individual trustees and trustee directors) – for example if they are directors or employees of the employer company.

Unhelpfully, although clearance is available to provide protection to third parties, the Regulator has also said that it will not give clearance to trustees who are concerned that their actions might expose them to this risk. This is rather odd, particularly as there is nothing in the legislation which precludes trustees from seeking clearance. Whilst generally speaking trustees are unlikely to be directly involved in action which might lead to a contribution notice being issued, this will not always be the case – particularly in circumstances where there is a restructuring of pension liabilities – and it seems rather unfair that all the other parties are able to seek the formal certainty of clearance.

Crime and punishment

There is, however, an even worse possibility than any form of civil liability or financial penalty – that of criminal liability for trustees.

Now, we think all trustees would accept that they would be exposed to criminal liability if they were to act fraudulently (just like they would in any aspect of their lives). However, there are also some breaches of technical statutory obligations which are a criminal offence and do not require fraudulent action by the trustees.

Examples include:

- breach of the restrictions on making employer-related investments;
- failure to provide information to Regulator or Pension Protection Fund or providing them with misleading information;
- using pension fund assets to meet civil penalties;
- carrying on regulated activity while unauthorised/not exempt (under the Financial Services and Markets Act 2000).

The penalties attached to these breaches are potentially extremely severe as these are indictable offences which carry up to two years in prison, or a fine, or both!

Trustee company liabilities

It is clear to us that being a trustee director can provide additional protection over and above the protection available for individual trustees (see below). However, being a trustee director also brings with it a whole raft of corporate responsibilities.

This is because trustee directors owe duties to the trustee company, for example general duties, such as skill and care (under the Companies Act 2006) plus more specific potential exposure to liability, such as liability for wrongful trading (under the Insolvency Act 1986).

Employer liabilities

Finally, on unusual liabilities, it is worth noting that if the trustee is an employer (e.g. of in-house administrators) then there will be the usual statutory employment liabilities. Further, some of these (e.g. unlawful discrimination) can result in personal liability not just for individual trustees but also trustee directors as well.

We also consider that trustees probably owe duties of care to pension scheme employers, as well as members. For example, in relation to investment decisions it will be the employer (who has to fund the scheme) rather than the scheme members that will generally lose out where poor investments have been made in breach of the investment requirements.

More "bad news": when trustee protection simply doesn't work

We have now covered six more unusual area of trustee liability. The second area of bad news is that the wide trustee protection that we described earlier often simply doesn't work because there are significant legal restrictions on the scope of the protection. Six key examples are:

Third party liabilities

It is often overlooked that exoneration clauses in pension scheme documentation can only limit a trustee's liability to beneficiaries of the trust (i.e. the employers and members). Such exoneration clauses will have no effect on a trustee's liability to third parties, such as advisers, investment managers and derivatives counter-parties. Unless the relevant contact is expressly limited, individual trustees will have personal liability.

Statutory duties

Statutory duties under the pensions legislation are probably not limited by an exoneration clause in the trust deed.

Investment functions

Under section 33 of the Pensions Act 1995, exoneration provisions and indemnities out of the fund do not work in relation to a trustee's duties to take care or exercise skill in the performance of investment functions. Section 33 also means that indemnities from the employer may not work for investment matters either – leaving a significant gap in trustee protection.

Fines and penalties

Indemnities out of the fund (and insurance paid for out of the fund) cannot cover criminal fines and civil penalties because this is prohibited by section 256 of the Pensions Act 2004. As noted above, breach of section 256 is a criminal offence, although rather bizarrely section 256 only applies to reimbursement of a trustee (and not expressly to reimbursement of a trustee director).

Breaching other duties

Trustee indemnities out of the fund may also not work if the trustee has broken another duty and owes money to the fund. This can be a concern for third parties, such as derivatives counterparties (particularly if there is a sole corporate trustee) as they have to rely on the indemnity from the fund to ensure that the trustee can meet its obligations under the derivative instrument. However, they could find that the indemnity is not available to the trustee (and hence not available to them) because of a completely unrelated breach of trust by the trustee.

Companies Act 2006

An indemnity from an employer to a trustee (or director of a trustee company) who is also a director of the indemnifying employer needs to comply with the Companies Act 2006 limitations. This means that it cannot cover fines/civil penalties or cost of defending criminal proceedings where director is convicted. If the indemnity attempts to cover such liabilities, then the whole indemnity may be void.

Some "good news": lesser known helpful facts

We appreciate that this article has so far focused on bad news trustee liability issues that a trustee might have preferred to remain ignorant of. However, there are some less well known points on trustee liability which are helpful in providing protection to trustees or in making it possible to obtain better protection for trustees.

Exonerations generally do work

We have focused on some key limitations on trustee exonerations above, but it is important to remember that (aside from those limitations), exonerations will generally apply in accordance with their terms.

Those terms can be extremely broad, although it will depend on the exact wording in the particular trust deed. Whilst an exoneration clause cannot apply in cases of actual fraud, they can be drafted to effectively excuse a trustee of anything less culpable including, for example, gross negligence: see Spread Trustee v Hutcheson (2011).

Former trustees are protected

Generally speaking, former trustees will usually remain covered by indemnity and exoneration clauses, although again, the extent of the protection will depend on the particular wording used.

Helpfully though, former trustees will be protected by an exoneration clause regardless of whether former trustees are expressly covered by the terms of the clause: see Seifert v Pensions Ombudsman (1996).

No liability for actions of fund manager

Although the ability of exoneration and indemnity clauses to protect trustees from liability for investment matters is severely restricted (see above), section 34(4) of the Pensions Act 1995 provides valuable protection for trustees for actions that have been delegated to the fund manager.

Section 34(4) provides that there will be no personal liability for the actions of the fund manager, provided that the trustees take all reasonable steps to:

- ensure that the fund manager has appropriate knowledge and experience; and
- appropriately monitor the fund manager's performance.

Indemnities and exonerations can be broadened

If the protection provided to the trustees in the trust deed appears to be inadequate, it may well be possible to amend the provisions to provide better or more comprehensive protection. Generally speaking, indemnities and exonerations may be widened if this is for a proper purpose (for example if it is necessary in order to attract new trustees), provided that there is no express restriction in the amendment power which would prohibit such a change. Extensions to the protection could include introducing a power to pay insurance premiums out of the fund (see Bogg v Rapier (1999); Dollar Academy (1995)).

Implied power to buy insurance?

Further, even where there is no express power to purchase insurance using fund assets, such a power may be implied if there is a power to pay trustees in the trust deed (because the insurance premiums can simply be part of trustee remuneration).

There are, however, special rules which may apply where a scheme is winding-up (which we will now cover here).

Protection following transfer to the Pension Protection Fund

If a pension scheme is transferred to the Pension Protection Fund, schedule 6 of the Pensions Act 2004 provides that trustees continue to be protected to the same extent as under the exoneration clause and indemnity from the scheme. However, trustees in those circumstances may still be vulnerable to the costs of defending a claim.

Directors of corporate trustees have more protection

As we mentioned above, our view is that directors of corporate trustees really do have more protection than individual trustees. This is because it is the trustee company that owes duties direct to the beneficiaries (and the directors do not) so it is the trustee company that is liable for any loss suffered by the scheme as a result of the breach of those duties rather than individual trustee directors.

There are some limits to the protection afforded by having a trustee company because some obligations apply directly (e.g. civil penalties – see above). Directors may also still be liable to the trustee company for any breach of the duties which they owe to the company. However, it is difficult for the beneficiaries to bring a derivative claim and so enforce this directly: HR v JAPT (1997); Gregson (2011) save where the trustees have acted dishonestly so that accessory liability may arise.

Time can run out for claims

Where a claimant has delayed in commencing proceedings against a pension trustee for breach of duty, the trustee may be able to rely on the Limitation Act 1980 to defend any claim. These are complex rules but can be worth investigating.

Conclusions

To horribly misquote the late great Oliver Hardy, trustee liability has the potential to be "another fine mess" for trustees to get into.

We hope that this article has highlighted some of the potential pitfalls and, where possible, how to avoid them.

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Trustee Liability Insurance: Q&A's

Why do we need insurance when we have an indemnity and an exoneration clause to protect us against claims?

An indemnity may be given by the scheme or the sponsoring employer company and many trustees will have the benefit of exoneration clauses within the trust deed and rules excluding them from liability. However, it is not always appreciated that such clauses are subject to statutory limits. For example, an exoneration or indemnity from the fund cannot operate for any breach of trust relating to investments and it is also prohibited for the scheme to indemnify trustees for civil fines and penalties. It should also be appreciated that an indemnity from the employer would be of no value upon an insolvency when the trustees are still having to manage the scheme.

Exoneration clauses are also subject to several other limitations including not affording protection from claims involving third parties and moreover, they will always be construed restrictively by the courts. In addition, the problem with relying purely on exoneration and indemnity provisions is that they merely transfer any liability between the trustees, the beneficiaries and the employer. Pension trustee liability insurance, however, will normally provide cover for the trustees, pension scheme and sponsoring employer.

Insurance provides an external source of protection and should stand in front of such indemnity clauses. In today's environment, trustees do not usually wish to "hide" behind exoneration clauses when facing valid claims from pension scheme members.

We have been told that we do not need trustee liability insurance as we are covered under the company's Directors & Officers policy, is that correct?

The answer depends on the poIicy wording and terms of cover. However, Directors & Officers (D&O) policies will often contain an exclusion for any acts or omissions while acting as a trustee or administrator of the pension scheme. Generally, it is not recommended that reliance be placed upon a D&O policy of insurance as the cover will not be tailored to meet the specialised circumstances relating to pensions and potentially there will be competing calls on the policy which are outside the control of the trustees.

Are any trustee liability concerns likely to arise from the change from RPI to CPI?

There may still be some uncertainty as to the impact following the changes announced by the Government. It is recommended that legal advice is sought to determine whether it is permissible for the individual scheme to do so based upon the Scheme's Rules and member communications.

Accordingly, trustees may now wish to allow the implementation of transfer value quotations if it is clear that they are permitted to do so under the Scheme's Rules. This is because the assumed rate of inflationary increase (both for revaluation of deferred pensions and increases to pensions once they are in payment) will affect the value of the pension being capitalised in a transfer value calculation. The actions of the trustees should be within the ambit of the cover under a trustee policy of insurance but proper due diligence procedures should be followed in any event.

Are we covered for past actions that were taken before the date that we take out insurance?

Trustee liability insurance operates on a "claims made" basis which means that there is potentially cover for claims made against the insured during the policy period irrespective of when the event giving rise to the claim occurred. Therefore, this is another reason to consider taking out insurance sooner rather than later to give protection for mistakes that might have already occurred in the past. However, this will be usually subject to not previously having had insurance and being unaware of the circumstance likely to give rise to the claim when purchasing insurance.

What is the position when a trustee retires – are they still covered?

A trustee's personal exposure does not cease when they retire and their post retirement situation may make them particularly vulnerable. Problems in pensions often take a considerable time after the event to materialise. It is important, therefore, to check that the position of retired trustees and pension managers is properly protected. The solution is for retired trustees to have the guarantee of cover in the event that the scheme ceases to be insured. They can then rest assured that they have cover personal to them, irrespective of what the employer or trustees have done, or not done, about insurance since they retired. It is again important to check the extent of cover provided in this respect as policies do vary (OPDU Elite provides lifetime cover for retired trustees thus giving valuable peace of mind). However, if the main policy of insurance is renewed each year then the cover for retired trustees should remain in place.

Have claims been made against trustees?

OPDU's own claims experience has seen issues which have involved individual claims sums of up to £20m to date. One common feature is, as one would anticipate, the importance of the accuracy of data and we encourage trustees therefore to ensure that regular data healthchecks are undertaken. Other issues which have given rise to problems and potential liabilities include: incorrect formulas used for calculating benefits; interpretation of Trust Deeds; over-payment of benefits; misapplication of Scheme Rules; seeking court directions; early retirement & ill-health disputes; rectification proceedings, accounting irregularities; DC choices of investment funds; Pension Sharing Orders; general administration errors; TUPE issues; misrepresentations by trustees; transfer values; incorrect quotations; discrepancies between scheme documentation and administration practice; delays in transfer and payments of benefit assets; PPF levy issues; incorrect scheme amendments and equalisation issues. OPDU

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